90-1924

No.____

Supreme Court, U.S.
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IN THE

SUPREME COURT OF THE UNITED STATES

October Term, 1990

STEPHEN J. BALLAY, ET AL.,
Petitioners,

vs.

LEGG MASON WOOD WALKER, INC.,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

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QUESTIONS PRESENTED

1. Is Section 12(2) of the Securities Act of 1933, which has no self-contained limitation on the scope of liability and applies by its terms to transactions and securities exempted from the registration requirements of the 1933 Act, restricted to sales of newly-issued securities and therefore inapplicable to aftermarket trading?

2. Is the judicially-created private right of action available under Section 10(b) of the Securities Exchange Act of 1934 the exclusive federal remedy for material misstatements and omissions made by sellers of outstanding securities?

LIST OF PARTIES

(Petitioners)

Stephen J. Ballay; Albert J. Bandosz; Susan Beebee; Peter C. Beebee; L. Nelson Behmer; Robert L. Behmer; Elizabeth W. Bell; Agnes M. Broccolini; John J. Burke, Jr.; Sophie Chelyk and John A. Zappitelli; Richard A. Deal; William W. Deal, Jr.; Carl Dudugjian, as Trustee; Bobbi S. Espinoza (Schimmel); George S. Flamm; Frank M. Flansburg; David G. and Jacqueline Gallaher; Sanford D. Goldfine; Arthur S. Goldman; Herbert E. Gould; Robert A. Hoover; Richard W. Jacobs; Charles J. and Phylliss A. Merriken; Edith L. Munger; Oren M. Persons, Jr.; Albert Resnick; Ronald and Lynn Richter; Edmund H. Robinson; Lawrence Smedley, as Trustee; Allen and Christine Smith; Peter Staniskis; Gary H. Uhrman; Philip A. Weyforth; Dennis Williamson; Michael J. and Anna 0. Zappitelli; Dunwoody Zook, for Melissa D. Zook and William H.D. Zook, II; and Suzanne C. Zook.

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No.____

IN THE

SUPREME COURT OF THE UNITED STATES

October Term, 1990

STEPHEN J. BALLAY, ET AL.,

Petitioners,

vs.

LEGG MASON WOOD WALKER, INC.,

Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

Petitioners, Stephen J. Ballay, et al., respectfully pray that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Third Circuit entered in this proceeding on February 15, 1991 (timely motion for rehearing en banc denied on March 21, 1991).

OPINIONS BELOW

The opinion of the Court of Appeals is reported at 925 F.2d 682 and appears in the Appendix hereto. The opinion of the District Court for the Eastern District of Pennsylvania on respondent's motion to dismiss petitioners' complaint is unreported and appears in the Appendix. The opinion of the district court on respondent's post-trial motions is unreported and appears in the Appendix. (Citations to the Appendix are made thus: App. 1, etc.).

JURISDICTION

The judgment of the Court of Appeals for the Third Circuit was entered on February 15, 1991, and a timely petition for rehearing en banc was denied on March 21, 1991. This petition for certiorari was filed within 90 days of that date. This Court's jurisdiction is invoked under 28 U.S.C. §1254(1).

STATUTORY PROVISIONS INVOLVED

1933 Securities Act, 15 U.S.C. §771 (reproduced verbatim at App. 58).

1933 Securities Act, 15 U.S.C. §77q (reproduced verbatim at App. 59-60).

1934 Securities Exchange Act, 15 U.S.C. §78j (reproduced verbatim at App. 61).

Securities and Exchange Commission Rule 10b-5, 17 C.F.R. §240.10b-5 (1990) (reproduced verbatim at App. 62).

STATEMENT OF THE CASE

Petitioners, a group of forty-one investors, sought damages in this action from their stockbrokerage firm, respondent Legg Mason Wood Walker, Inc. ("Legg Mason"), for violations of the federal securities laws. In June of 1986, a securities analyst employed by Legg Mason recommended the purchase of the common stock of Wickes Companies, Inc. ("Wickes"). This purchase recommendation was based, in part, upon the analyst's miscalculation of the net book value of a share of Wickes common stock.[1] According to the analyst, the book value

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1. The "net book value" or "net asset value" of a share of stock is computed by subtracting the value of a company's intangible assets (goodwill, patents, etc.) from the value of its total assets. The difference between a company's tangible assets and current liabilities/shareholder equity is then divided by the number of outstanding securities. (925 F.2d at 685-86 n.4; App. 8 n.4). As calculated above, "[b]ook value can be a guide in selecting underpriced stocks

of Wickes common stock net of goodwill constituted a "proxy for the liquidation value of the company," (R. 635a), and as such provided a "floor" below which the trading price of the company's stock should not fall.

The Wickes purchase recommendation was initially transmitted orally during an interstate telephone conference call to each of Legg Mason's branch offices. During this conference call, the analyst represented that the book value of Wickes common stock net of goodwill was $5.00 a share. Petitioner John Burke, who in June of 1986 was the branch manager of respondent's Bryn Mawr, Pennsylvania office, participated in the conference call. In reliance upon the oral representations concerning the net book value of Wickes common stock, Mr. Burke invested his own funds in the securities of Wickes and recommended that many of his longstanding clients do likewise.[2]

Unbeknownst to petitioners, Legg Mason had included substantial amounts of goodwill in the Wickes book value calculation.[3] Respondent's oral and written

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and is an indication of the ultimate value of securities in liquidation." *Ibid.*

2. In addition to the oral representations made by Legg Mason relative to the net book value of Wickes securities, the Research Department also disseminated written reports pertaining to Wickes. In two of these written reports the figure given by Legg Mason for the book value of Wickes common stock was expressly represented as "excluding goodwill." (925 F.2d at 686; App. 8-9). These misstatements were "corrected" by Legg Mason in subsequent written reports published in December of 1987 and January of 1988. The subsequent reports disclosed for the first time that respondent's book value calculation for Wickes common stock *included* rather than *excluded* goodwill.

3. During 1986, the amount of purchased goodwill carried by Wickes as an asset increased by $800 million, and by January 31, 1987 Wickes was carrying in excess of $1 billion in purchased goodwill as an asset on its balance sheet. This "asset" accounted for approximately one-quarter of the current value of Wickes' total asset base. (R. 355a).

representations concerning net book value were therefore gross overstatements of the value of Wickes common stock in liquidation. Consequently, what the petitioners thought was a safe investment with limited downside risk proved disastrous. During the 24-month time period following the initial purchase recommendation, the stock became almost worthless and petitioners sustained damages in excess of $1,000,000.00. None of the petitioners would have purchased the securities of Wickes if they had been advised that the book value calculation provided by Legg Mason included goodwill.

Petitioners brought suit in the United States District Court for the Eastern District of Pennsylvania claiming that respondent's misstatements as to the net book value of Wickes common stock violated Section 12(2) of the 1933 Securities Act and Section 10(b) of the 1934 Securities Exchange Act.[4] After a one-week trial, the jury found in favor of petitioners on their claims against Legg Mason under Section 12(2) of the Securities Act, and against petitioners on their claims under Section 10(b) of the Securities Exchange Act. In response to a special interrogatory, the jury specifically found that the Research Department began misrepresenting the net book value of Wickes common stock in June of 1986, the time at which respondent first recommended the purchase of Wickes securities. After respondent's post-trial motions were denied and the Court of Appeals declined to accept Legg Mason's interlocutory appeal, judgment was entered in favor of petitioners in the amount of $1,129,496.55.

On appeal, the Court of Appeals for the Third Circuit vacated the judgment rendered in favor of petitioners under Section 12(2), holding that the "plain meaning" of the phrase "prospectus or oral communication" as used in Section 12(2) disclosed an intent by Congress to limit the statute to "material misrepresentations made in a

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4. The district court's jurisdiction was based upon 28 U.S.C. §1331.

prospectus or in an oral communication related to a prospectus or initial offering." (925 F.2d at 688; App. 14). This conclusion was based, in part, upon the Court of Appeals' determination that the term "prospectus" as used in Section 12(2) is "a term of art which describes the transmittal of information concerning the sale of a security in an initial distribution." (*Ibid.*). After considering the legislative history of the 1933 Act, the Court of Appeals concluded that Congress had failed to specifically disclose its intent that Section 12(2) apply to aftermarket trading and therefore the statute was limited to initial offerings of stock. As additional support for its interpretation of the scope of liability under the statute, the Court of Appeals reasoned that application of Section 12(2) to secondary trading would "overrule, *sub silentio,* section 10(b) as a remedy for purchasers." (925 F.2d at 692-93; App. 25-26). Because none of the Wickes securities purchased by petitioners in this case were part of an initial offering of stock, the Court of Appeals held that Section 12(2) was unavailable as a remedy and the jury verdict in favor of petitioners was reversed.

REASONS FOR GRANTING THE WRIT

I.

THE DECISION OF THE COURT OF APPEALS INVOLVES QUESTIONS OF BROAD PUBLIC IMPORTANCE WHICH HAVE NOT BEEN, BUT SHOULD BE, SETTLED BY THIS COURT CONCERNING THE APPLICABILITY OF SECTION 12(2) OF THE 1933 SECURITIES ACT TO AFTERMARKET TRADING AND THE EXCLUSIVITY OF THE PRIVATE DAMAGE REMEDY IMPLIED UNDER SECTION 10(b) OF THE 1934 SECURITIES EXCHANGE ACT.

The question of whether Section 12(2) of the 1933 Securities Act applies to negligent misstatements made

by brokers concerning securities traded in the aftermarket is one of first impression for this Court. Resolution of this issue will determine whether brokers and other sellers of securities are subject to an obligation under the federal securities laws to exercise reasonable care in making statements calculated to solicit the purchase of an outstanding security. In the absence of the protection afforded to investors by Section 12(2), sellers will be free to solicit purchases of outstanding securities by means of negligent misrepresentations and omissions with complete immunity from civil liability under the federal securities laws.

In *United States v. Naftalin,* 441 U.S. 768, 777-78, 99 S. Ct. 2077, 2084, 60 L. Ed. 2d 624 (1979), this Court held that Section 17 of the 1933 Securities Act, the criminal antifraud section of the Act, applies to aftermarket trading. The question presented here is whether Section 12(2), which has been described as the "civil liability analogue to Section 17," 1 Loss & Seligman, *Securities Regulation* 384 (3rd ed. 1989), is likewise applicable to aftermarket trading. In no previous case decided by this Court has the applicability of Section 12(2) to aftermarket transactions been challenged.[5] Therefore, this Court has not as yet had the occasion to settle the important question of whether Section 12(2), like Section 17, applies to sales of outstanding securities. This question is of broad public importance. Its resolution will affect every individual in this country who is solicited by a stockbroker to invest in outstanding securities. This question also implicates issues which directly affect the efficient and consistent administration of the federal securities laws and should be settled by this Court.

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5. *E.g., Wilko v. Swan,* 346 U.S. 427, 74 S. Ct. 182, 98 L.Ed. 168 (1953) (remanding for trial a Section 12(2) case involving oral misrepresentations made by a broker concerning outstanding securities), *overruled on other grounds, De Quijas v. Shearson/American Express, Inc.,* 490 U.S. 477, 109 S. Ct. 1917, 104 L. Ed. 2d 526 (1989).

A. This Court Has Not, But Should, Settle the Important Question of Whether Section 12(2) of the 1933 Securities Act Applies to Sales of Securities Traded in the Aftermarket.

For the past five decades, investors have been permitted without judicial comment to assert claims against brokers under Section 12(2) for misstatements and omissions made in connection with sales of outstanding securities.[6] The first appellate court case addressing the scope of liability under Section 12(2) was decided in 1940, and involved a claim by an investor that a broker had induced the purchase of an outstanding security by means of an oral misrepresentation. *Cady, supra,* 113 F.2d at 989-90. In rejecting the broker's contention that he was not a "seller" of the security within the meaning of Section 12(2), the First Circuit held that the statute "imposes a liability for misrepresentations not only upon principals, but also upon brokers when selling securities owned by other persons." *Id.* at 990.

Cady was decided shortly after the passage of the 1933 Securities Act, and the applicability of Section 12(2) to secondary market transactions was not questioned by the parties or the Court. Similarly, in *Schillner, supra,* 134 F.2d at 877, the Second Circuit affirmed a liability verdict entered against a broker under Section 12(2) for oral misstatements made in connection with a security traded in the secondary market. Like *Cady, Schillner* was decided decades ago, and neither the

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6. *E.g., Cady v. Murphy,* 113 F.2d 988, 990 (1st Cir.), *cert. denied,* 311 U.S. 705, 61 S. Ct. 175, 85 L. Ed. 458 (1940); *Schillner v. H. Vaughan Clark & Co.,* 134 F.2d 875, 877 (2d Cir. 1943); *Monetary Management Group v. Kidder, Peabody & Co., Inc.,* 615 F. Supp. 1217, 1219-20 (E.D.Mo. 1985); *Yancoskie v. E.F. Hutton & Co., Inc.,* 581 F. Supp. 88, 90 (E.D.Pa. 1983); *Demoe v. Dean Witter & Co.,* 476 F. Supp. 275, 277 (D. Alaska 1979); *Herring v. Hendison,* 218 F. Supp. 419, 419-20 (S.D.N.Y. 1963); *Wilko v. Swan,* 127 F. Supp. 55, 56-57 (S.D.N.Y. 1955).

parties nor the Court challenged the applicability of Section 12(2) to secondary market transactions.[7]

The vitality of *Cady* and *Schillner* was reaffirmed by this Court in *Pinter v. Dahl,* 486 U.S. 622, 108 S.Ct. 2063, 100 L. Ed. 2d 658 (1988). In *Pinter,* this Court resolved the question of whether brokers are subject to liability as sellers of securities under Section 12 of the 1933 Act. Citing both *Cady* and *Schillner,* this Court held that:

> The applicability of §12 to brokers and others who solicit securities purchases has been recognized frequently since the passage of the Securities Act. It has long been quite clear that when a broker acting as an agent of one of the principals to the transaction successfully solicits a purchase he is a person from whom the buyer purchases within the meaning of §12 and is therefore liable as a statutory seller.

486 U.S. at 646, 108 S.Ct. at 2078, 100 L. Ed. 2d 658.

The cases in which Section 12(2) has been applied to aftermarket transactions recognize, as this Court did in *Pinter,* that solicited purchase transactions inherently involve the potential for abusive selling practices. As Justice Blackmun stated in *Pinter:*

> [S]olicitation of a buyer is perhaps the most critical stage of the selling transaction. It is the first stage of a traditional securities sale to involve the buyer, and is directed at producing the sale. In addition, brokers

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7. The first case to directly hold that Section 12(2) is limited to initial offerings was *SSH Co., Ltd. v. Shearson Lehman Brothers, Inc.,* 678 F. Supp. 1055 (S.D.N.Y. 1987). By suggesting below that application of Section 12(2) to aftermarket trading is a "novel" idea, respondent was apparently able to convince the Court of Appeals that it took over a half-century following the passage of the 1933 Securities Act for the courts to realize that Section 12(2) is limited to initial offerings, and that, therefore, *Cady, Schillner,* and every other Circuit and district court which had permitted investors to utilize the statute in a secondary trading context were simply oblivious to the restrictions on the scope of Section 12(2).

> and other solicitors are well positioned to control the flow of information to a potential purchaser, and, in fact, such persons are the participants in the selling transaction who most often disseminate material information to investors. Thus, solicitation is the stage at which an investor is most likely to be injured, that is, by being persuaded to purchase securities without full and fair disclosure.

486 U.S. at 646-47, 108 S. Ct. at 2078, 100 L. Ed. 2d 658.

The potential for injury to investors during the solicitation process exists regardless of the context of the transaction. Brokers solicit the purchase of both newly-issued and outstanding securities, and, in both instances, "are well positioned to control the flow of information to a potential purchaser." *Ibid.* It is during the solicitation process, moreover, that "brokers may well bolster the sales pitch with oral representations" which result in damage to an investor. *Elysian Federal Savings Bank v. First Interregional Equity Corp.*, 713 F. Supp. 737, 750 & n.17 (D.N.J. 1989). In the aftermath of the stock market crash of 1929, Congress was certainly aware of the dangers created by overreaching sales practices. Sections 12(2) and 17, "the antifraud sections of the Act,"[8] were intended by Congress to deter overzealous and abusive selling practices by requiring persons who solicit securities purchases to exercise reasonable care.[9] Requiring solicitors to exercise reasonable care protects the investing public by ensuring that sellers temper and control their sales pitch. Since it is the seller's affirmative act of solicitation which renders

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8. *Barnes v. Osofsky*, 373 F.2d 269, 272 (2d Cir. 1967).

9. Sections 12(2) and 17(a)(2) contain virtually identical language, *compare* 15 U.S.C. §771(2) *with id.*, §77q(a)(2), and both subject brokers and other sellers of securities to liability for negligence. *Id.*, §771(2); *Aaron v. SEC*, 446 U.S. 680, 697, 100 S. Ct. 1945, 1956, 64 L. Ed. 2d 611 (1980).

Sections 12(2) and 17 applicable to the transaction, it is not unduly harsh to require the seller to exercise reasonable care.

B. This Court Has Not, But Should, Settle the Important Question of Whether the Private Right of Action Available Under Section 10(b) of the 1934 Securities Exchange Act is the Exclusive Federal Remedy Afforded to Purchasers for Selling Abuses Committed in the Aftermarket.

This Court first considered the relationship between Section 12(2) and Rule 10b-5 in *Ernst & Ernst v. Hochfelder,* 425 U.S. 185, 96 S. Ct. 1375, 47 L. Ed. 2d 668 (1976). In *Hochfelder,* this Court noted that Rule 10b-5 was created by the Securities and Exchange Commission because none of the express rights of action contained in either the 1933 Act or the 1934 Act gave a remedy to defrauded sellers. *Id.,* 425 U.S. at 212 n.32, 96 S. Ct. at 1390 n.32, 47 L. Ed. 2d 668. The implied remedy which exists under Rule 10b-5 was intended to close a "loophole" in the federal securities laws. *Ibid.* As the Tenth Circuit held in *Gilbert v. Nixon,* 429 F.2d 348, 355 (10th Cir. 1970):

> [A] private right of action under Rule 10b-5 originated in the need for a seller's remedy where none had otherwise been provided. Once a remedy was implied for the seller, it was extended to include the buyer even though relief was already available to him under Section 12(2).

Since Section 12(2) provides an express rather than an implied remedy, this Court held in *Hochfelder* that negligence actions could not be asserted under Rule 10b-5 because to do so "would allow causes of action covered by Sections 11, 12(2), and 15 to be brought instead under Section 10(b) and thereby nullify the effectiveness of the carefully drawn procedural restrictions on these express rights of action." *Id.,* 425 U.S. at 210, 96 S. Ct. at 1389, 47 L. Ed. 2d 668.

Despite this Court's comments in *Hochfelder,* the Court of Appeals held that the express remedy under Section 12(2) could not coexist with the implied remedy under Rule 10b-5 in a secondary trading context. Reasoning that application of Section 12(2) to aftermarket transactions would render the implied damage remedy afforded under Rule 10b-5 superfluous, the Court of Appeals postulated that:

> If it were determined that section 12(2) applies to secondary market trading, the more lenient requirements of section 12(2) would effectively eliminate the use of section 10(b) by securities purchasers. Such a construction would overrule, *sub silentio,* section 10(b) as a remedy for purchasers.

(925 F.2d at 692-93; App. 25-26). This conclusion is premised entirely upon the erroneous supposition that the implied damage remedy available under Section 10(b) would be completely displaced if Section 12(2) applies to brokerage transactions involving purchases of outstanding securities.

Section 12(2) is only available to an investor if the defendant solicited a securities purchase motivated by a desire to further his own pecuniary interests or those of the securities' owner. *Pinter, supra,* 486 U.S. at 647, 108 S.Ct. at 2078, 100 L. Ed. 2d 658. Rule 10b-5 by contrast is not limited to solicited purchase transactions. It applies, *inter alia,* to sales made by persons trading on the basis of inside information even though there are no direct dealings between the seller and buyer, to "tippees" who sell securities on the basis of inside information in an impersonal market, to collateral participants in a securities sale who aid and abet a primary violation of Rule 10b-5, and to "churning" of discretionary trading accounts. Because none of these activities involve the direct solicitation of a securities purchase, Section 12(2) is unavailable as a remedy and relief will only lie under Rule 10b-5.

In substance, by holding that Section 12(2) is limited solely to initial offerings the Court of Appeals effectively transformed Rule 10b-5 into the exclusive federal remedy for misstatements and omissions made by sellers in connection with aftermarket trading.[10] This interpretation of the relationship between the express civil remedies contained in the 1933 Act and the implied remedy available under Rule 10b-5 was expressly rejected by this Court in *Herman & MacLean v. Huddleston,* 459 U.S. 375, 103 S. Ct. 683, 74 L. Ed. 2d 548 (1983). In *Huddleston,* this Court held that an investor was free to pursue claims under both the express negligence provisions of Section 11 of the 1933 Act and the implied right of action under Rule 10b-5. *Id.,* 459 U.S. at 387, 103 S. Ct. at 690, 74 L. Ed. 2d 548. Thus, the mere fact that solicited purchase transactions in a secondary trading context can give rise to liability under both Section 12(2) and Rule 10b-5 does not mandate the conclusion that Section 12(2) is inapplicable to aftermarket trading. As long as the purposes of the two provisions are different, a cumulative construction of the remedies afforded by Section 12(2) and Rule 10b-5 furthers the remedial purposes of the securities statutes. *Id.,* 459 U.S. at 381-88, 103 S. Ct. at 686-90, 74 L. Ed. 2d 548.

Section 12(2) was intended by Congress to provide a buyer with "a special right to recover for misrepresentation which differs substantially from the common-law action [for fraud] in that the seller is made to assume the burden of proving lack of scienter." *Wilko v. Swan, supra,* 346 U.S. at 431, 74 S. Ct. at 184, 98 L. Ed. 168. Section 10(b) by contrast was intended by Congress to function as a "catchall clause to enable the [Securities

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10. With the exception of Section 12(2), no other provision of the 1933 Act or the 1934 Act even arguably prescribes an express remedy for misstatements or omissions made by sellers to purchasers during secondary market transactions. *See* 15 U.S.C. §§77k, 77l(1), 77o, 78i, 78p, 78r, 78t.

and Exchange] Commission to deal with *new* manipulative or cunning devices." *Hochfelder,* 425 U.S. at 203, 96 S. Ct. at 1385, 47 L. Ed. 2d 668 (1976) (emphasis supplied). Section 10(b) did not create an express civil remedy "and there is no indication that Congress, or the Commission when adopting Rule 10b-5, contemplated such a remedy." *Id.,* 425 U.S. at 196, 96 S. Ct. at 1382, 47 L. Ed. 2d 668. In view of the evolution of the private remedy under Rule 10b-5, and in particular its creation by judicial implication rather than legislative action, it is patently incorrect to suggest that Congress intended Rule 10b-5 to function as the exclusive civil remedy for misrepresentations made by brokers to secondary market purchasers.

The Court of Appeals' conclusion that Rule 10b-5 is the exclusive civil remedy for misstatements made by sellers to secondary market purchasers ascribes a meaning and purpose to Section 10(b) of the 1934 Act and Rule 10b-5 that neither this Court, Congress, nor the Securities and Exchange Commission contemplated. Such a conclusion erroneously presumes that Congress purposefully chose to hold brokers responsible under Section 17 of the 1933 Act for misstatements made to purchasers in secondary market transactions, yet nevertheless opted to immunize such individuals from civil liability under Section 12(2) for the same conduct. This decision by Congress, in turn, required the Securities and Exchange Commission to promulgate an administrative rule, pursuant to a statutory "catch-all" provision, which, after a private damage remedy was implied by the courts, became the exclusive federal remedy for misstatements made by sellers in connection with secondary trading. Congress should not be presumed to have acted in such an illogical and haphazard fashion. An interpretation of Section 12(2) which results in the conclusion that Rule 10b-5 is the exclusive remedy for misstatements made by brokers to securities purchasers in a secondary trading context neither is, nor should be, good law.

II.

THE COURT OF APPEALS INCORRECTLY HELD THAT SECTION 12(2) OF THE 1933 SECURITIES ACT IS INAPPLICABLE TO AFTERMARKET TRADING BASED UPON AN ANALYSIS WHICH IS INCONSISTENT WITH THE LANGUAGE OF THE STATUTE, THE LEGISLATIVE HISTORY OF THE STATUTE, THE POSITION OF THE SECURITIES AND EXCHANGE COMMISSION, AND THE COMMENTATORS.

A. The Court of Appeals' Restrictive Construction of the Term "Prospectus" Contained in Section 12(2) is Unprecedented and Should Not be Sanctioned by This Court.

Section 12(2) provides for liability if a person solicits an offer to purchase any security "by means of a prospectus or oral communication" which contains a misstatement or omission of material fact. 15 U.S.C. §771(2). The linchpin of the Court of Appeals' analysis of the scope of liability under Section 12(2) is its interpretation of the term "prospectus" within the phrase "prospectus or oral communication" contained in Section 12(2). Without citation to authority, the Court of Appeals held that "Congress employed the term 'prospectus' as a term of art which describes the transmittal of information concerning the sale of a security in an initial distribution." (925 F.2d at 688; App. 15). By adopting this construction of the term "prospectus," the Court of Appeals was able to conclude that the "plain language" of Section 12(2) indicated that Congress intended to limit liability under the statute to "material misrepresentations made in a prospectus or in an oral communication related to a prospectus or initial offering." (925 F.2d at 688; App. 14). This interpretation of the term "prospectus" is unprecedented and at odds with both the statutory definition of the term and the legislative history of the 1933 Act.

"Prospectus" is defined in Section 2(10) of the Securities Act as:

> any prospectus, notice, circular, advertisement, letter, or communication, written or by radio or television, which offers *any* security for sale or confirms the sale of *any* security . . . .

15 U.S.C. §77b(10) (emphasis supplied). In commenting upon the term "prospectus" as used in the 1933 Act, the House Report unequivocally states that Congress intended in Section 2(10) to "define[] prospectus broadly as including any written or radio communication offering a security for sale." H. Rep. No. 85, 73rd Cong., 1st Sess. 12 (1933). The term "prospectus" is therefore defined expansively, and if Congress had meant to limit the term "prospectus" to communications describing securities distributed pursuant to an initial offering, it could easily have done so.

The "broad" definition of the term "prospectus" in Section 2(10) prompted the General Counsel of the Securities and Exchange Commission to conclude in 1941 that:

> [T]he term 'prospectus' as used in the Securities Act covers more than the kind of formal document which the layman ordinarily has in mind when he uses the term. Under the Act a 'prospectus' includes *every kind of written communication which attempts or offers to dispose of, or solicits an offer to buy, a security for value.* If the term 'prospectus' is construed in accordance with its language and spirit, it must in my opinion be read to cover *any document* which is designed to procure orders for a security, or to effectuate the disposition of a security, whether or not the document purports on its face to offer the security for sale, or otherwise to dispose of it for value.

11 Fed. Reg. 10964 (1946) (emphasis supplied).

The operative language of Section 12(2), and in particular the term "prospectus" as defined in Section 2(10) of the Act, is broad and expansive and provides no basis for judicially engrafting a limitation on the scope of liability under the statute. With the exception of the Court of Appeals in this case, no court, scholar, or commentator has ever construed the term "prospectus" in the 1933 Securities Act as "describ[ing] the transmittal of information concerning the sale of a security in an initial distribution." (925 F.2d at 688; App. 15). The converse, in fact, is true.[11] Ironically, one of the scholars relied upon by the Court of Appeals, Professor Thomas Hazen, criticizes the very analysis adopted in this case:

> [A] few decisions have held that Section 12(2) applies only to distributions of securities and not to after-market transactions. The court reached this conclusion from the fact that the statute refers to *prospectus* or oral communication. There is no evidence that such a limitation on Section 12(2)'s scope is warranted. Section 2(10) of the Act defines prospectus as a written offer to sell without any indication that it is limited to offers in a distribution. Thus, the better view is that Section 12(2) applies regardless of the context of the sale, provided that there has been use of the jurisdictional means.

Hazen, *Treatise on the Law of Securities Regulation* §7.5 at page 318 (2d ed. 1990) (emphasis in the original).[12]

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11. Section 12(2) "prospectuses include every written communication or advertisement offering a security for sale." Douglas & Bates, *The Federal Securities Act of 1933,* 43 Yale L.J. 171, 189 (1933). Professors Jennings and Marsh similarly note that "Section 12(2) covers an 'oral communication' containing a false statement, as well as a 'prospectus' in the sense of any written communication." Jennings & Marsh, *Securities Regulation* 841 (4th ed. 1977).

12. In addition to Professor Hazen, the scholars and commentators have uniformly concluded that Section 12(2) applies to aftermarket trading. Professor Loss describes the scope of Section

Despite the expansive definition of the term "prospectus" in Section 2(10) of the Act, the Court of Appeals concluded that the legislative history of the Securities Act revealed that Congress intended that only Section 17 apply to secondary trading, and that the remainder of the statutory scheme was limited to initial offerings of stock. (925 F.2d at 691-92; App. 21-24). Neither the House Report nor the Senate Report on the 1933 Act contain a definitive statement that Section 12(2) is restricted to initial offerings, and when Section 12(2) is specifically discussed in the House Report the phrase "selling statements" was used by the Committee to describe the types of communications giving rise to liability under the statute. H. Rep. No. 85, 73rd Cong., 1st Sess. 23 (1933). The phrase "selling statements" is perfectly consistent with the broad definition of the term "prospectus" contained in Section 2(10) of Securities Act and provides no basis for limiting the scope of liability under Section 12(2) to initial offerings.

12(2) as follows: "To start with what is clearest, the Section applies to all sales of securities, whether or not registered and whether or not the particular security is exempted from Section 5 . . ." Loss, *Fundamentals of Securities Regulation* 887 (2nd ed. 1988). Professors Bromberg and Lowenfels concur: "§12(2) not only covers a securities distribution in the technical sense to which §11 is confined but covers trading in outstanding securities as well." Bromberg & Lowenfels, *Securities Fraud and Commodities Fraud* Vol. 2, §5.2(600) at page 5:6.40 (1985); *accord* Bloomenthal, *Securities Law Handbook* §11.05 at pages 284, 287-88 (1987-88 ed.); Steinberg, *The Propriety and Scope of Cumulative Remedies Under the Federal Securities Laws,* 67 Cornell L. Rev. 557, 585-86 n.179 (1982); Steinberg, *Section 17(a) of the Securities Act of 1933 After Naftalin and Redington,* 68 Geo. L.J. 163, 180 (1979); Jennings & Marsh, *Securities Regulation* 841 (4th ed. 1977); Kaminsky, *An Analysis of Securities Litigation Under Section 12(2) and How It Compares with Rule 10b-5,* 13 Hous. L. Rev. 231, 236 (1976); Brudney & Chirlstein, *Corporate Finance* 740 (1972); Folk, *Civil Liabilities Under the Federal Securities Act: The Barchris Case,* 55 Va. L. Rev. 199, 201 (1969).

B. The Court of Appeals' Restrictive Construction of the Term "Prospectus" Contained in Section 12(2) Renders the Separate and Distinct Remedies Provided by Sections 11 and 12(2) of the 1933 Act Redundant and Duplicative and Should Not be Sanctioned by This Court.

Unless exempted from registration, the 1933 Securities Act requires that before a new issue of securities can be sold to the public a registration statement and accompanying prospectus must be filed with the Securities and Exchange Commission. 15 U.S.C. §§77e, 77j.[13] With the exception of Section 12(2), all of the express civil remedies prescribed in the Securities Act concern the registration requirements of the Act. *Id.*, §§77k, 77l(1). As Judge Easterbrook of the Seventh Circuit Court of Appeals recently held:

> Section 11 deals with errors and omissions in registration statements, including that portion of the registration statement that circulates as the prospectus. Section 12(1) deals with sales 'in violation of section 5' — that is, unregistered sales of securities required to be registered. Section 12(2) addresses all other forms of materially incorrect or misleading selling literature and oral communications in the sale of a security.

Short v. Belleville Shoe Mfg. Co., 908 F.2d 1385, 1390 (7th Cir. 1990). Each of the express statutory remedies available under the Securities Act are therefore designed to reach separate and distinct forms of misconduct.

The Court of Appeals concluded in this case that the "prospectus" referred to in Section 12(2) is the formal

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13. Sections 3 and 4 of the Securities Act list specific types of securities and transactions which are exempted from the registration requirements of the Act. 15 U.S.C. §§77c, 77d. Unless one of these exemptions apply, a security can only be sold to the public if it has been registered with the Securities and Exchange Commission. *Id.*, §77e.

prospectus which is filed with the Securities and Exchange Commission as part of the registration statement and that, therefore, liability under the statute is limited to initial offerings. (925 F.2d at 688-89; App. 14-17). As noted in *Short,* however, material misstatements or omissions contained "in registration statements, including that portion of the registration statement that circulates as the prospectus," are actionable under Section 11 of the Securities Act. 908 F.2d at 1390. To hold, as the Court of Appeals did here, that Section 12(2) was also intended by Congress to provide a remedy for defects in an initial offering prospectus renders Sections 11 and 12(2) redundant and duplicative. If Congress had intended to limit civil liability under the 1933 Act to misstatements and omissions contained in an initial offering prospectus, adding Section 12(2) to the statutory scheme would not have been necessary.

The fact that Congress enacted Section 12(2) demonstrates that it intended to provide a remedy for conduct separate and distinct from that which gives rise to liability under Section 11. This conclusion is dictated not only by common sense, but by the language and structure of the 1933 Act as well. Unlike Section 11, Section 12(2) applies to any transaction involving the sale of any security "whether or not exempted" under Sections 3 or 4 from the registration requirements of the Act. 15 U.S.C. §771(2).[14] Therefore, to determine the scope of liability under Section 12(2) the transactions and securities which are exempt from registration in Sections 3 and 4 must be examined.

Under Section 4(4) of the Act, "brokers' transactions executed upon customers' orders on any exchange or in

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14. "None of the exemptions in either §3 or 4 extends to the provisions of §17 or the provision in §12(2) creating civil liability for the sale of securities by misleading statements or omissions." 3 Loss & Seligman, *Securities Regulation* 1144 (3rd ed. 1989); *see also Kubik v. Goldfield,* 479 F.2d 472, 477 (3d Cir. 1973); *Wilko, supra,* 127 F. Supp. at 58; *Moore v. Gorman,* 75 F. Supp. 453, 456 (S.D.N.Y. 1948).

the over-the-counter market" are exempted from the registration requirements of the Securities Act. 15 U.S.C. §77d(4). In explaining the purpose for this exemption, the House Report states that the provision was intended to:

> [E]xempt the ordinary brokerage transaction. Individuals may thus dispose of their securities according to the method which is now customary without any restrictions imposed upon either the individual or the broker.

H. Rep. No. 85, 73rd Cong., 1st Sess. 16 (1933). Although this provision exempts brokerage transactions from the registration requirements of the Act, thereby precluding liability under Section 11, such transactions are subject to the requirements of Section 12(2).

In addition to brokerage transactions, at the time the Securities Act was passed a specific exemption for outstanding securities was created by Congress. Under former Section 3(a)(1), the registration requirements were inapplicable to sales of any security which:

> [P]rior to or within sixty days after the enactment of this Act, ha[d] been sold or disposed of by the issuer or bona fide offered to the public . . . .

H.R. 5480, 73rd Cong., 1st Sess. §3(a)(1) (1933) (repealed 1987). As noted in the Senate Report on the 1933 Securities Act, the purpose for this provision was to exempt from registration "securities which ha[d] been issued and outstanding in the hands of the public prior to the date of approval of the act." S. Rep. No. 47, 73rd Cong., 1st Sess. 4 (1933). Thus, while brokers could sell outstanding securities without regard to the registration requirements of the Securities Act, Section 12(2) was intended by Congress to provide a civil remedy if the sale

was accomplished by means of a material misstatement or omission.[15]

The only other provision of the 1933 Securities Act which Congress made applicable to exempted transactions and securities is Section 17. 15 U.S.C. §77q(c). In *Naftalin, supra,* 441 U.S. at 777-78, 99 S. Ct. at 2084, 60 L. Ed. 2d 624, this Court held that Section 17 applies to aftermarket trading. It makes little sense to conclude that Congress would make *both* Sections 12(2) and 17 applicable to exempted transactions and securities, create liability under *both* provisions for negligent misrepresentations, utilize virtually identical language in *both* Sections 12(2) and 17(a)(2) to describe the type of conduct giving rise to liability, and then arbitrarily conclude that brokers should be immunized from civil liability under Section 12(2) for secondary market transactions.

III.

THE DECISION OF THE COURT OF APPEALS IS INCONSISTENT WITH DECISIONS IN OTHER CIRCUITS CONCERNING THE SCOPE OF LIABILITY UNDER SECTION 12(2) OF THE 1933 SECURITIES ACT.

In addition to the cases discussed previously,[16] several other Circuit Courts have expressly stated that the protection afforded to investors by Section 12(2) applies to aftermarket transactions. In *Barnes, supra,* 373 F.2d at 272, the Court of Appeals for the Second

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15. Congress was certainly capable of excepting from the operation of Section 12(2) any of the categories of securities exempted from registration in Section 3. In fact, such an exception from Section 12(2) was created with respect to government securities exempted from registration in Section 3(a)(2). 15 U.S.C. §§77c(a)(2), 771(2). Thus, if Congress had wished to exclude outstanding securities from the scope of Section 12(2) it could easily have done so.

16. *Short, supra,* 908 F.2d at 1390; *Schillner, supra,* 134 F.2d at 877; *Cady, supra,* 113 F.2d at 989-90.

Circuit held that Sections 12(2) and 17, unlike Section 11, are not limited in scope to newly-issued securities:

> Section 11 deals with civil liability for untrue or misleading statements or omissions in the registration statement; its stringent penalties are to ensure full and accurate disclosure through registration. Since under §2(1) and 6, only individual shares are registered, it seems unlikely that the section developed to insure proper disclosure in the registration statement was meant to provide a remedy for other than the particular shares registered. *In contrast, §§12(2) and 17, the antifraud sections of the Act, where some form of the traditional scienter requirement dispensed with as to the issuer under §11, is preserved, are not limited to newly registered securities.* [emphasis supplied]

And in *Woodward v. Wright,* 266 F.2d 108 (10th Cir. 1959), the Court of Appeals for the Tenth Circuit emphasized that Section 12(2):

> [I]s applicable to the sale of all securities . . . whether exempt from the registration requirements or not, or whether the sellers were issuers for the purpose of a public offering or not.

Id. at 116.

The issue of whether Section 12(2) applies to aftermarket trading will continue to vex the lower courts until this Court decides the question. As it is, the district courts are badly divided, and in the absence of a definitive ruling from this Court the confusion and dissension surrounding this issue will only persist.[17] This Court

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17. The following cases hold that Section 12(2) applies to aftermarket trading; *Farley v. Baird, Patrick & Co., Inc.,* 750 F. Supp. 1209, 1219 (S.D.N.Y. 1990); *In re Ramtek Securities Litigation,* [Current Binder] Fed.Sec.L.Rep. ¶95,814 (N.D.Ca. 1990); *Hoxworth v. Blinder, Robinson & Co., Inc.,* Civil Action Nos. 88-0285, 88-0286, 88-0307 (E.D.Pa. May 23, 1989) (LEXIS, Genfed library, Dist. file); *Elysian Federal, supra,* 713 F. Supp. at

should therefore grant certiorari in this case to eliminate the confusion among the courts as to whether Section 12(2) of the 1933 Securities Act applies to aftermarket trading.

747-51; *Scotch v. Moseley, Hallgarten, Estabrook & Weeden*, 709 F. Supp. 95, 97-8 (M.D.Pa. 1989); *Wilko, supra*, 127 F. Supp. at 58-60. The following cases hold that Section 12(2) is limited to initial offerings; *Cox v. Bateman Eichler, Hill Richards, Inc.*, No. C-90-15139 (N.D.Ca. October 25, 1990) (LEXIS, Genfed library, Dist. file); *T. Rowe Price Horizons Fund v. Preletz*, Civil Action No. 90-230 (D.Md. October 19, 1990) (LEXIS, Genfed library, Dist. file); *Grinsell v. Kidder, Peabody & Co.*, 744 F. Supp. 931, 932-34 (N.D.Ca. 1990); *Mix v. E.F. Hutton & Co., Inc.*, 720 F. Supp. 8, 11-12 (D.D.C. 1989); *McGowan v. Dean Witter Reynolds, Inc.*, [1989 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶94,423 (S.D.N.Y. 1989); *Strong v. Paine Webber, Inc.*, 700 F. Supp. 4, 5 (S.D.N.Y. 1988); *SSH Co., supra*, 678 F. Supp. at 1059; *Ackerman v. Clinical Data, Inc.*, [1985-86 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶92,207 (S.D.N.Y. 1985); *Bresson v. Thompson McKinnon Securities, Inc.*, 641 F. Supp. 338, 342 (S.D.N.Y. 1986); *Panek v. Bogucz*, 718 F. Supp. 1228, 1231-33 (D.N.J. 1989); *Cheltenham Bank v. Drexel Burnham Lambert, Inc.*, [1989 Transfer Binder] Fed. Sec.L.Rep. (CCH) ¶94,391 (E.D.N.C. 1989); *Leonard v. Shearson Lehman/American Express, Inc.*, 687 F. Supp. 177, 179-80 (E.D.Pa. 1988); *First Union Brokerage v. Milos*, 717 F. Supp. 1519, 1522-23 (S.D.Fla. 1989); *Ralph v. Prudential-Bache Securities, Inc.*, 692 F. Supp. 1322, 1325 (S.D.Fla. 1988).

CONCLUSION

For the foregoing reasons a writ of certiorari should issue to review the judgment and opinion of the Court of Appeals for the Third Circuit.

Respectfully submitted,

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APPENDIX

Filed February 15, 1991

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

Nos. 90-1412 and 90-1427

BALLAY, STEPHEN J., BANDOSZ, ALBERT J., BEEBEE, SUSAN, BEEBEE, PETER C., BEHMER, L. NELSON, BEHMER, ROBERT L., BELL, ELIZABETH W., BROCCOLINI, AGNES M., BURKE, JR., JOHN J., ZAPPITELLI, SOPHIE CHELYK and JOHN A., DEAL, RICHARD A., DEAL, JR., WILLIAM W., DUDUGJIAN, CARL, as Trustee, ESPINOZA (SCHIMMEL), BOBBI S., FLAMM, GEORGE S., FLANSBURG, FRANK M., GALLAGHER, DAVID G. and JACQUELINE, GOLDMAN, ARTHUR S., GOULD, HERBERT E., HOOVER, ROBERT A., JACOBS, RICHARD W., MERRIKEN, CHARLES J. and PHYLLISS A., MUNGER, EDITH L., PERSONS, JR., OREN M., RESNICK, ALBERT, RICHTER, RONALD and LYNN, ROBINSON, EDMUND H., SMEDLEY, L., as Trustee, SMITH, ALLEN and CHRISTINE, UHRMAN, GARY H., WEYFORTH, PHILIP A., WILLIAMSON, DENNIS, ZAPPITELLI, MICHAEL J. and ANNA O., ZOOK, DUNWOODY, for ZOOK, MELISSA D., and ZOOK, II, WILLIAM H.D., and ZOOK, SUZANNE C., GOLDFINE, SANFORD D., STANISKIS, PETER

vs.

LEGG MASON WOOD WALKER, INC.

Appellant in 90-1412

BALLAY, STEPHEN J., BANDOSZ, ALBERT J., BEEBEE, SUSAN, BEEBEE, PETER C., BEHMER, L. NELSON, BEHMER, ROBERT L., BELL, ELIZABETH W., BROCCOLINI, AGNES M., BURKE, JR., JOHN J., ZAPPITELLI, SOPHIE CHELYK and JOHN A., DEAL, RICHARD A., DEAL, JR., WILLIAM W., DUDUGJIAN, CARL, as Trustee, ESPINOZA (SCHIMMEL), BOBBI S., FLAMM, GEORGE S., FLANSBURG, FRANK M., GALLAHER, DAVID G. and JACQUELINE, GOLDMAN, ARTHUR S., GOULD, HERBERT E., HOOVER, ROBERT A., JACOBS, RICHARD W., MERRIKEN, CHARLES J. and PHYLLISS A., MUNGER, EDITH L., PERSONS, JR., OREN M., RESNICK, ALBERT, RICHTER, RONALD and LYNN, ROBINSON, EDMUND H., SMEDLEY, L., as Trustee, SMITH, ALLEN and CHRISTINE, UHRMAN, GARY H., WEYFORTH, PHILIP A., WILLIAMSON, DENNIS, ZAPPITELLI, MICHAEL J. and ANNA O., ZOOK DUNWOODY, for ZOOK, MELISSA D., and ZOOK, II, WILLIAM H.D., and ZOOK, SUZANNE C., GOLDFEIN, SANFORD D., STANISKIS, PETER

vs.

LEGG MASON WOOD WALKER, INC.

STEPHEN J. BALLAY; ALBERT J. BANDOSZ; SUSAN BEEBEE; PETER C.BEEBEE; NELSON L. BEHMER; ROBERT L. BEHMER; ELIZABETH W. BELL; AGNES M. BROCCOLINI; JOHN J. BURKE, JR.; SOPHIE CHELYK AND JOHN A. ZAPPITELLI; RICHARD A. DEAL; WILLIAM W. DEAL, JR.; CARL DUDUGJIAN, AS TRUSTEE; BOBBI S. ESPINOZA (SCHIMMEL); GEORGE G. FLAMM; FRANK M. FLANSBURG; DAVID G. AND

JACQUELINE GALLAGHER; SANFORD D. GOLDFINE; ARTHUR S. GOLDMAN; HERBERT E. GOULD; ROBERT A. HOOVER; RICHARD W. JACOBS; CHARLES J. AND PHYLLISS A. MERRIKEN; EDITH L. MUNGER; OREN M. PERSONS, JR.; ALBERT RESNICK; RONALD AND LYNN RICHTER; EDMUND H. ROBINSON; L. SMEDLEY, AS TRUSTEE; ALLEN AND CHRISTINE SMITH; PETER STANISKIS; GARY H. UHRMAN; PHILIP A. WEYFORTH; DENNIS WILLIAMSON; MICHAEL J. AND ANNA O. ZAPPITELLI; DUNWOODY ZOOK, FOR MELISSA D. ZOOK AND WILLIAM H.D. ZOOK, II; AND SUZANNE C. ZOOK,-

Appellants in 90-1427

Appeal from the United States District Court
for the Eastern District of Pennsylvania
(D.C. Civil No. 88-06867)

Argued
December 10, 1990
Before: SLOVITER and MANSMANN,
Circuit Judges, and
DEBEVOISE, *District Judge*.*

(Filed February 15, 1991)

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* Honorable Dickinson R. Debevoise of the United States District Court for the District of New Jersey, sitting by designation.

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OPINION OF THE COURT

MANSMANN, *Circuit Judge*.

In this lawsuit brought by the named investors against their brokerage firm, Legg Mason Wood Walker, Inc. ("Legg Mason"), for alleged oral misrepresentations made concerning the book value calculation of securities, two issues require resolution in this appeal following a jury trial. The first presents an issue not yet ruled upon by any federal appellate court: whether section 12(2)

of the Securities Act of 1933 affords a remedy to a buyer of securities in the secondary market.[1] This question is purely one of statutory construction which implicates our plenary standard of review. *Chrysler Credit Corp. v. First Nat'l Bank and Trust Co.*, 746 F.2d 200, 202 (3d Cir. 1984); *Universal Minerals, Inc. v. C.A. Hughes & Co.*, 669 F.2d 98, 101-02 (3d Cir. 1981). We believe that the language and the legislative history of section 12(2) demonstrate that Congress did not there intend to protect buyers in the aftermarket, and we hold that section 12(2) provides a remedy to buyers of securities only in the initial distributions. The district court thus erred as a matter of law in sending this count of the complaint to the jury. We will reverse the judgment of the district court on this count and remand for the entry of judgment in favor of Legg Mason.

Our resolving this initial issue in favor of Legg Mason requires that we determine whether the investors are entitled to a new trial on their count under section 10(b) of the 1934 Securities

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1. *See* Hoxworth v. Blinder, Robinson & Co., Inc., 903 F.2d 186, 203 (3d Cir. 1990) (noting no appellate decision on this issue as of May 9th). This issue has been litigated in the federal district courts more frequently since 1976 when the Supreme Court ruled in Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976), that proof of scienter is a requirement for a section 10(b) claim under the 1934 Securities Exchange Act. The standard under section 12(2) is, however, a lesser, negligence, standard. *See* Hazen, A Look Beyond the Pruning of Rule 10b-5: Implied Remedies and Section 17(a) of the Securities Act of 1933, 64 Va. L. Rev. 641, 644 n.15 (1978) (predicting increased usage of section 12(2) following *Hochfelder*). In addition, the measure of damages available under section 12(2) is greater than under section 10(b). *Hoxworth*, 903 F.2d at 203, 203 n.25.

Exchange Act. We must address whether the district court erred in refusing to charge the jury that the investors' reliance upon their broker John Burke, as their agent, could establish their section 10(b) claim. We find that, at most, this omission constituted harmless error. For this reason we will affirm the judgment of the district court on this second count.

I.

It is well settled that, on appeal, the verdict winner is entitled to have all the facts and inferences therefrom, as reflected by the jury's verdict, construed in its favor. We state the facts here in light of that standard.

The investors include 41 Legg Mason clients, their stockbroker John Burke, an investor himself, and an additional Legg Mason client, Sanford Goldfine, a client of a different Legg Mason broker. The investors purchased securities of Wickes Company, Inc. through Legg Mason during the period from June 1986 through August 1987. The parties have stipulated that Legg Mason earned commissions for those sales.

According to Burke, who served as Legg Mason's Bryn Mawr, Pennsylvania branch manager, Legg Mason is a full service brokerage house[2] which subscribes to a value philosophy of investing. Employing this value philosophy, Legg Mason promotes investment in the undervalued stock of companies that show potential for future growth. Legg Mason's Anthony Pearce-Batten, a securities

2. According to the testimony, full service brokerage firms provide clients with investment counseling services in contrast to discount firms which merely follow client orders to purchase and sell stock.

analyst in Legg Mason's Baltimore, Maryland research department, articulated this philosophy as "look[ing] for out of favor situations which possess characteristics in one form or another that gives one the basis for believing that there is limited risk involved with investing in those stocks." Typically, "out of favor situations" would involve purchasing securities from companies that have recently emerged from bankruptcy or reorganization, as had Wickes. Investing in these companies is attractive because, according to Legg Mason's theory, these companies present little "downside" risk.

At trial Legg Mason produced evidence that numerous factors weighed in the calculation of value, of which goodwill was only one. The investors, however, argued that because the value investment philosophy is predicated on the approximate equivalence between the purchase price of aggregate shares and liquidation value, intangible assets, such as goodwill,[3] which are not readily sold in a liquidation, should not be included in a company's tangible assets for purposes of estimating the downside risk.

Wickes emerged from bankruptcy in January 1985 and its president subsequently engaged in restructuring maneuvers to strengthen the company's financial health. In addition, Wickes acquired holdings in wallcoverings and furnishings and sold others in apparel and hosiery. According to Legg Mason research reports, this restructuring boded well for Wickes' future. Nevertheless, some of the reports suggested that only those investors

3. According to the investors' expert testimony, goodwill "represents the amount of money that is paid in the purchase of another firm in excess of what the market value of all the assets of that firm are worth."

more willing to tolerate risk invest in Wickes securities.

Batten recommended investment in Wickes from June of 1986 through November of 1987. These recommendations, according to John Burke, were made orally by means of an interoffice "squawk box" to the Bryn Mawr branch office and also in various written communications circulated to Legg Mason's brokers and clients. Burke testified that in 1986 he heard Batten report over the "squawk box" that Wickes had a book value[4] of $5.00 per share excluding goodwill.

An August 10, 1987, Legg Mason research report concerning Wickes suggested that "positives outweigh the negatives – buy," and listed Wickes' book value per share at $23.70.[5] The report also stated: "It is worth observing that current assets

4. Book value, according to the investors' excerpt from Barron's Dictionary of Finance and Investment Terms, admitted into evidence, is defined as:

> net asset value of a company's securities calculated by using the following formula:
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> > Total assets *minus* intangible assets (goodwill, patents, etc.) *minus* current liabilities *minus* any long-term liabilities and equity issues that have a prior claim (subtracting them here has the effect of treating them as paid) *equals* total net assets available for payment of the issue under consideration.
>
> The total net asset figure divided by the number of . . . shares of . . . stock, gives the *net asset value*—or book value—per . . . share of . . . stock.
>
> Book value can be a guide in selecting underpriced stocks and is an indication of the ultimate value of securities in liquidation.

5. The book values, which vary from $5.00 to $23.70, reflect a five to one reverse stock split.

comprise almost two thirds of Wickes' $3.5 billion asset base *net of goodwill* ..." (emphasis added). Another Legg Mason report, dated August 25, 1987, included a computation of Wickes' book value per share of stock at $25.00 with the notation "(excludes goodwill)." A third and undated Legg Mason document also recommended the purchase of Wickes securities and included the statement that "... with the stock presently selling at less than 40 percent of stated book value (*excluding goodwill*), any share repurchases would generate substantial equity growth" (emphasis added). A Legg Mason vice president, David Nelson, admitted that all of these references to goodwill were erroneous.

In its defense, Legg Mason contended that these references were "merely typographical errors" made "after the vast majority of the investors had already purchased their shares of Wickes." Further, Legg Mason corrected these misstatements in both the November 27, 1987, and the December 17, 1987, reports which clarified that much of the stated book value consisted of goodwill. Moreover, David Nelson, who supervised the research department during this period, testified that these written misrepresentations had not even been discovered until after the investors initiated their lawsuit.

In their Amended Complaint, the investors pled causes of action under section 12(2) of the 1933 Securities Act, 15 U.S.C. § 771(2), and section 10(b) of the 1934 Securities Exchange Act, 15 U.S.C. § 78j. Because sixteen of the investors had signed customer contracts containing arbitration provisions, Legg Mason moved for a stay of all proceedings and to compel arbitration of these investors' claims. The district court ordered the

common law and the 1934 Securities Exchange Act claims to arbitration, but denied the motion to compel arbitration of the 1933 Securities Act claims. Legg Mason appealed and we affirmed the district court. *Ballay v. Legg Mason Wood Walker, Inc.*, 878 F.2d 729 (3d Cir. 1989).

While the appeal was pending, the district court conducted a week long trial on the liability portion of those counts not ordered to arbitration, including the 1933 Act claims of the sixteen plaintiffs who had signed the customer agreements, and all the claims of the remaining plaintiffs.[6]

In their pretrial memorandum and proposed jury instructions on the section 10(b) claim, the investors raised a theory of agency liability and requested that the district court give a charge that read, in part, that "...as a matter of law John Burke was acting as the agent for all investors at the time they purchased securities in Wickes". The district court refused to give this instruction.

The jury found for Legg Mason on the section 10(b) claim and for the investors on their section 12(2) claim, and in answer to a special interrogatory, the jury specified a violation date of June, 1986.

Legg Mason moved, *inter alia*, for judgment N.O.V. and for a new trial, asserting that section 12(2) should not be applied to secondary markets. The district court denied the motions, applying section 12(2) to aftermarket trading, reasoning that the plain language of section 12(2) did not limit its application to initial distributions of securities and that the broad remedial purposes of the

6. The investors withdrew additional counts of common law "aiding and abetting" and controlling person liability under 15 U.S.C. §§ 77o, 78t.

Securities Act of 1933 were not rigidly restricted to initial distributions. The district court found particularly persuasive the Supreme Court's application of section 17 of the 1933 Act, section 12(2)'s criminal analogue, to secondary markets. *See United States v. Naftalin*, 441 U.S. 768 (1979). Therefore, the district court confirmed its earlier conclusion, reached in denying Legg Mason's Motion to Dismiss, that section 12(2) applied to secondary market trading. The court then certified for interlocutory appeal the issue of "whether [section 12(2)] can be applied to fraud occurring in the secondary markets." We denied Legg Mason's petition for interlocutory appeal. After the parties stipulated as to damages, the district court entered its judgment against Legg Mason for $1,129,496.55.

Legg Mason here appeals the district court's conclusion that section 12(2) applies to secondary market trading.[7] The investors cross-appeal the district court's refusal to charge the jury on their agency theory of section 10(b) liability; they ask for a new trial on that count in the event that we determine that section 12(2) does not apply to the aftermarket.[8] We hold that because the jury found

7. With the exception of the materiality of its misrepresentations concerning the exclusion of goodwill from book value, Legg Mason does not challenge any of the factual elements of a section 12(2) cause of action. Because we hold that section 12(2) does not provide a cause of action to buyers in secondary trading, we do not reach the issue of materiality.

8. Although all the investors are listed in the Notice of Appeal, presumably those investors raising the agency theory of liability are only those clients of John Burke. Obviously neither John Burke nor Sanford Goldfine, who used another broker at Legg Mason, can advance this agency theory.

against John Burke on his section 10(b) claim, the investors cannot prevail on their agency theory. Therefore, the district court's refusal to charge the jury on this theory constituted, at most, harmless error.

II.

The resolution of our first issue, whether section 12(2) of the 1933 Act creates a cause of action for an oral misrepresentation in the secondary market, requires that we begin with the precise language of section 12(2). *See Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 197 (1976) (the starting point in every case involving statutory construction is the statutory language). Section 12 reads:

> Any person who –
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> (1) offers or sells a security in violation of § 77(e) of this title, or
>
> (2) offers or sells a security (whether or not exempted by the provisions of § 77(c) of this title other than paragraph (2) of subsection (a) of said section), by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, *by means of a prospectus or oral communication*, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known of such untruth or omission, shall be liable to the person purchasing such security from him, who may sue

> either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

15 U.S.C. § 77l (emphasis added).

As its language suggests, section 12(2) provides a remedy and rescissionary damages, only to a purchaser of securities against an offeror or seller of securities in the event that

1. Defendants offered or sold a security;
2. By the use of any means of communication in interstate commerce;
3. Through a prospectus or oral communication;
4. By making a false or misleading statement of a material fact or by omitting to state a material fact necessary in order to make the statements, in light of the circumstances under which they were made, not misleading;
5. Plaintiff did not know of the untruth or omission; and
6. Defendants knew, or in the exercise of reasonable care, could have known of the untruth or omission.

Monetary Management Group, Inc. v. Kidder, Peabody & Co., Inc., 615 F. Supp. 1217, 1222 (D.C. Mo. 1985).

Crucial to our resolution of whether section 12(2) applies to the secondary market is the

meaning of the words "oral communication" in the phrase "prospectus or oral communication." Because the 1933 Act does not define "oral communication," we must interpret the plain meaning of these words in light of their context in the statute and in keeping with the intent of Congress in passing the 1933 Act. *See K Mart Corp. v. Cartier, Inc.*, 486 U.S. 281, 291 (1988)("if the statute is clear and unambiguous, that is the end of the matter, for the court . . . must give effect to the unambiguously expressed intent of Congress.")

We agree with both parties that the words "prospectus or oral communication" must be construed as related terms. We are persuaded that the plain meaning of the words "prospectus or oral communication" together is that buyers may recover for material misrepresentations made in a prospectus or in an oral communication related to a prospectus or initial offering. *See Schreiber v. Burlington Northern, Inc.*, 472 U.S. 1, 8 (1985) ("words grouped in a list should be given related meaning") (citation omitted). This reading comports with the canon of construction *noscitur a sociis*, which instructs that a provision should not be viewed "in isolation but in light of the words that accompany it and give [it] meaning." *Massachusetts v. Morash*, 490 U.S. 107, 109 S. Ct. 1668, 1673 (1989). As the Supreme Court noted when construing the meaning of one term in a phrase:

> [t]he maxim *noscitur a sociis*, that a word is known by the company it keeps, while not an inescapable rule, is often wisely applied where a word is capable of many meanings in order to avoid the giving of unintended breadth to the Acts of Congress.

Jarecki v. G.D. Searle & Co., 367 U.S. 303, 307 (1961).

The fact that "oral communication" keeps company with "prospectus" suggests, as both parties have admitted, that the more general term be limited to conform to the more restrictive term where consonant with the legislative intent. We deduce no evidence that Congress intended an expansive meaning of oral communication unconnected to the term "prospectus." Congress defined the term "prospectus" as any "prospectus, notice, circular, advertisement, letter, or communication, written or by radio or television, which offers any security for sale or confirms the sale of any security," in section 2(10), 15 U.S.C. § 77b(10).

We believe that Congress employed the term "prospectus" as a term of art which describes the transmittal of information concerning the sale of a security in an initial distribution. In addition to its definition, the use of the term "prospectus" in various sections of the 1933 Act supports a reading restricted to initial distributions. Section 10 of the 1933 Act, 15 U.S.C. § 77j, which mandates the information required in a prospectus, clearly ties a prospectus with registration statements filed with the Securities Exchange Commission. For example, a prospectus shall contain the information required in a registration statement, but may omit some documents required of registration statements. 15 U.S.C. § 77j(a)(1). Section 10(a)(3) provides for current information in a prospectus used over nine months from the effective date of the registration statement. 15 U.S.C. § 77j(a)(3). Even an abbreviated prospectus authorized by section 10(b), 15 U.S.C. § 77j(b), which is not subject to

the registration statement requirements of section 11, 15 U.S.C. § 77k, must be filed with the registration statement. Further, under section 5(b)(1), 15 U.S.C. § 77e(b)(1), a prospectus not meeting the requirements of section 10 may not be used in interstate commerce to sell registered securities. In addition, in its award of special powers to the Securities Exchange Commission, Congress gave the Commission power to amend requirements for "registration requirements and prospectuses." 15 U.S.C. § 77s. Thus Congress repeatedly used the term "prospectus" in provisions concerning registration statement requirements in initial distributions.

As well, the exemptions[9] Congress provided to the definition of "prospectus" in section 2(10) are consistent with the overall policy to ensure full disclosure to purchasers in batch offerings. These provisions permit offerors of securities to provide additional information to potential investors that is not subject to the requirements of section 10 where these communications either merely add to information previously provided the investor in the form of a section 10 prospectus, or clearly "state[] from whom a written prospectus meeting the requirements of [section 10] may be obtained."

Therefore reading "prospectus" expansively would be contrary to the definition of the word "prospectus" as defined and used in the 1933 Act.

9. Congress provided two exemptions to the definition of prospectus in section 2(10): (1) a communication provided to the investor after the date of registration if a prior written prospectus had been furnished to that investor, and (2) a notice, circular, advertisement, letter or communication which refers to a section 10 prospectus and does no more than identify the security, its price, and by whom orders will be executed. 15 U.S.C. § 77b(10).

If it had intended an expansive meaning for the term "prospectus", Congress more simply could have drafted section 12(2) to describe all "written or oral communications". *See* 2A Singer, *Sutherland Stat. Const.* § 47.29 (4th ed. 1984) ("[i]n the absence of legislative intent to the contrary, or other overriding evidence of a different meaning, technical terms or terms of art used in a statute are presumed to have their technical meaning") (footnotes omitted).

As the jury verdict in this case demonstrates, an expansive reading of "oral communication" would permit a buyer to recover under section 12(2) for mere misrepresentations where that same buyer could not meet the scienter, reliance, and causation elements of a section 10(b) claim. Specifically because recovery under section 10(b) requires proof of scienter, mere negligent misrepresentation is not actionable under section 10(b). For a section 10(b) claim, something more, such as fraud, must be proven. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976) ("'scienter' – intent to deceive, manipulate, or defraud" is required for a private cause of action under section 10(b) and Rule 10b-5). Section 12(2), on the other hand, makes actionable negligent misrepresentation absent proof of scienter or fraud. Interpreting section 12(2) so that "oral communication" refers to both initial and secondary trading, then, would create an anomaly in that sellers in the aftermarket would be liable only for oral and not written misrepresentations because the term "prospectus" is limited to initial offerings. Legg Mason would thus be liable only for Batten's oral misrepresentation made over the "squawk box", but not for the three written reports containing the same misrepresentations. This distinction makes no logical sense.

III.

A.

We have to this point limited our examination to the language of section 12(2) alone to conclude that it should not be expanded to aftermarket trading. In addition, the "object and structure of the Act as a whole" support this interpretation based upon the maxim *noscitur a sociis*. *See Dole v. United Steelworkers of America*, __ U.S. __, 110 S. Ct. 929, 935 (1990) (reviewing legislative purpose and structure to interpret phrase).

The "object" of the 1933 Act informs our view of section 12(2). During the aftermath of the 1929 stock market crash, Congress sought to stabilize the market and reduce fraud through the passage of the Securities Act of 1933 and the Securities Exchange Act of 1934. *See* H.R. Rep. No. 85, 73d Cong., 1st Sess. 1, 2 (1933); Conference Report, H.R. Rep. No. 1838, 73d Cong., 2d Sess., 1 (1934). Together these statutes regulate both initial issuances and aftermarket trading of securities. *Hochfelder*, 425 U.S. at 195. Neither statute preempts recovery under either common law. 15 U.S.C. § 77p.

With the Securities Act of 1933, Congress sought to establish safeguards for investors in batch offerings of securities by establishing registration and disclosure requirements designed in part to protect investors from fraud and to promote ethical standards of honesty and fair dealing. *Hochfelder*, 425 U.S. at 195. The Securities Exchange Act of 1934, on the other hand, was enacted "to provide for the regulation of securities exchanges and of over-the-counter markets operating in interstate and foreign commerce and through the mails, to prevent inequitable and unfair practices on such

exchanges and markets and for other purposes." *In Re Data Access Systems Sec. Litigation*, 843 F.2d 1537, 1548 (3d Cir.), *cert. den. sub. nom., Vitiello v. I. Kahlowsky & Co.*, 488 U.S. 849 (1988).[10] While Congress intended that *both* statutes would protect investors against fraud, *Data Access*, 843 F.2d at 1548, the more specific intent with respect to the 1933 Act controls here where the statutory language requires a restrictive reading and Congress did not express a contrary intent.[11]

Congress' intent in enacting the 1933 Act was clearly to regulate initial offerings. In the House Report accompanying the 1933 Act, the legislators specifically stated:

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10. While the Acts generally address initial (1933) and secondary distributions (1934), we have noted that the 1934 Act consisted of two parts: amendments to the 1933 Act and the Securities Exchange Act of 1934. *Data Access*, 343 F.2d at 1548.

11. We are persuaded by the guidance of the Supreme Court that

> generalized references to the "remedial purposes" of the securities [acts] will not justify reading a provision "more broadly than its language and the statutory scheme reasonably permit."

See Aaron v. SEC, 446 U.S. 680, 695 (1980) (citations omitted) (holding that the SEC is required to prove scienter in an action brought under section 17(a)(1) but not sections 17(a)(2) and (3)); *Touche Ross & Co. v. Redington*, 442 U.S. 560, 578 (1979) (invoking the remedial purposes of the 1934 Act does not justify reading a private right of action into section 17(a)); *SEC v. Sloan*, 436 U.S. 103, 116 (1978) (rejecting the suggestion that section 12(k) of the 1934 Act should be construed to permit a more "satisfactory remedy" absent support in its language and the statutory scheme).

> The bill affects only new offerings of securities sold through the use of the mails or of instrumentalities of interstate or foreign transportation or communication. It does not affect the ordinary redistribution of securities unless such redistribution takes on the characteristics of a new offering by reason of the control of the issuer possessed by those responsible for the offering.

H.R. No. 85, 73d Cong., 1st Sess. 7 (1933); *see also, e.g., Panek v. Bogucz*, 718 F. Supp. 1228, 1232 (D.N.J. 1989) (noting the thrust of the 1933 Act to offer protection to investors in initial offerings); *Mix v. E.F. Hutton & Co., Inc.*, 720 F. Supp. 8, 12 (D.D.C. 1989) (citing *United States v. Naftalin*, 441 U.S. 768 (1979), to describe purpose of 1933 Act to prevent fraud in initial distributions); *Ralph v. Prudential-Bache Sec., Inc.*, 692 F. Supp. 1322, 1324 (S.D. Fla. 1988) (same). Nothing in the legislative history or structure of the 1933 Act indicates that Congress intended to broaden section 12(2) beyond the Act's principal purpose of regulating the distribution of new offerings. *Cf. Mix*, 720 F. Supp. at 8 (holding section 12(2) restricted to initial distributions absent clear congressional mandate to read section 12(2) expansively).

In addition, the "structure" of the Act supports the more narrow reading of section 12(2). *See Dole*, ___ U.S. ___, 110 S.Ct. at 935, 936 (looking to language and import of other statutory provisions). Section 12(2) follows section 11 and section 12(1), which govern the registration of securities and create civil liability for sales of unregistered securities and appears before section 13, which provides the statute of limitation for both sections

11 and 12. All of these sections deal with initial distributions. 15 U.S.C. §§ 77k, 77l(1). Congress' placement of section 12(2) squarely among 1933 Act provisions concerned solely with initial distributions of securities indicates that it designed section 12(2) to protect buyers of initial offers against fraud and misrepresentation.

B.

Although the 1933 and 1934 Acts generally regulate initial distributions and secondary trading of securities respectively, two antifraud provisions, section 17(a) of the 1933 Act and section 10(b) of the 1934 Act, explicitly apply to *all* trading. The investors urge us to extend section 12(2) similarly to all markets.

Section 17(a) of the 1933 Securities Act, 15 U.S.C. § 77q(a), proscribes fraudulent conduct and makes it a crime. *Wilko v. Swan*, 127 F. Supp. 55, 58 (S.D.N.Y. 1955); *see* Steinberg, Section 17(a) of the Securities Act of 1933 after *Naftalin* and *Redington*, 68 Geo. L. Rev. 163, 177 (1979). Because the language of section 17(a)(2) and of section 12(2) is similar, these sections have been referred to as civil and criminal analogues. Since the Supreme Court has held Section 17(a) applicable to secondary markets, the investors urge that by analogy section 12(2) ought also to be interpreted expansively. *United States v. Naftalin*, 441 U.S. 768 (1979). We decline this suggestion, however, because the language of the two sections differs materially and we do not find the reasoning of the Supreme Court for expanding the reach of section 17(a) applicable to section 12(2).

Although some of the language of section 17(a)(2), making unlawful certain conduct "by

means of any untrue statement [or omission] of a material fact . . ." closely parallels sections 12(2)'s language, there are important and significant differences. Section 17(a) lacks the phrase "prospectus or oral communication" contained in section 12(2) and instead proscribes, as unlawful, conduct employed "*directly or indirectly* ... to obtain money or property by means of any untrue statement ...." 15 U.S.C. § 77q(a) (emphasis added). These words – "directly or indirectly" – convey a legislative intent to encompass all conduct meeting the other elements of a section 17(a) claim. The words "prospectus or oral communication," in contrast, do not encompass the universe of methods as do "directly and indirectly." In fact, inclusion of "prospectus or oral communication" in section 17(a) would eviscerate the word "indirectly".[12]

We are also convinced that the reasons underlying the *Naftalin* holding that section 17(a) of the 1933 Act applies to both initial and aftermarket transactions do not apply to section 12(2). In *Naftalin*, the Court found that "[n]othing on the face of the statute" supported Naftalin's

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12. Section 17(a) reads in its entirety:

> It shall be unlawful for any person in the offer or sale of securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, *directly or indirectly* –
>
> (1) to employ any device, scheme, or artifice to defraud, or
>
> (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

reading that section 17(a)(1) applied only to initial distributions of stock; the statutory language, according to the Court, made "no distinction" between initial and secondary tradings. *Naftalin*, 441 U.S. at 778. Naftalin's suggestion that the phrase "upon a purchaser" in section 17(a)(3) should be grafted onto section 17(a)(1) to exclude secondary tradings was rejected; each subsection "proscribes a distinct category of misconduct" as evidenced by use of the conjunctive "or". *Naftalin*, 441 U.S. at 773, 774. Moreover, Congress made its intent for unrestricted use of section 17(a) explicit in the legislative history: "[t]he Act subjects the sale of old or outstanding securities to the same criminal penalties and injunctive authority for fraud, deception, or misrepresentation as in the case of new issues put out after the approval of the act." *Naftalin*, 441 U.S. at 778 (quoting S. Rep. No. 47, 73d Cong., 1st Sess., 4 (1933)).

In contrast to section 17(a), section 12(2) has no such clear legislative mandate. The legislative history is devoid of any indication that the reach of section 12(2) was intended to be broader than the limited scope of sections 11 and 12(1). Although Congress specifically stated that the antifraud provision of section 17(a) was meant to reach secondary markets as well as initial distributions, it failed to make the same application with respect to section 12(2). We recognize that legislative history can be a legitimate guide to discovering a statutory purpose obscured by ambiguity, but "[i]n the absence of a

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(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

15 U.S.C. § 77q(a) (1976) (emphasis added).

'clearly expressed legislative intention to the contrary,' the language of the statute itself 'must ordinarily be regarded as conclusive . . . .'" *United States v. James*, 478 U.S. 597, 606 (1986) (quoting *Consumer Product Safety Comm'n v. GTE Sylvania, Inc.*, 447 U.S. 102, 108 (1980)).

The language of section 12(2) is more narrowly drawn than that of section 17(a). The plain words, "directly or indirectly" and "*any* device" of section 17(a), differ from the specific "prospectus or oral communication" language of section 12(2). Had Congress intended section 12(2) to extend to liability for secondary transactions, it could have preceded "oral communication" with "any" and explicitly stated its special intent in the legislative history. The fact that the pertinent legislative history concerning section 12 makes no distinction between section 12(1) and section 12(2) with respect to their application to initial offerings, as opposed to aftermarket trading, contrasts with the clear legislative intent concerning the scope of section 17(a).

C.

In concluding that section 12(2) claims apply only to initial offerings, we are mindful that the 1933 and 1934 Acts should be construed *in pari materia*, that is, as coordinating statutes which contain some overlapping provisions. *See Herman & McLean v. Huddleston*, 459 U.S. 375, 390 (1983)(sections that address "different types of wrongdoing," may prohibit some of the same conduct). Nevertheless, one provision should be narrowly interpreted, when consistent with legislative intent, so as not to eviscerate requirements for recovery under another complementary provision. As the verdict in this

case particularly demonstrates, the application of section 12(2) to secondary trading would permit purchasers of securities to prevail against sellers in instances where those purchasers cannot recover under section 10(b) of the Securities Exchange Act of 1934.

Under section 10(b) and its implementing rule, 10b-5, a purchaser of securities may bring a private cause of action. *Hochfelder*, 425 U.S. at 1986; *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975). The elements of proof required and damages recoverable under section 10(b), however, differ substantially from those of section 12(2). In contrast to section 10(b), section 12(2) requires no proof of scienter or reliance, and embodies a more relaxed standard of causation. If it were determined that section 12(2) applies to secondary market trading, the more lenient requirements of section 12(2) would effectively eliminate the use of section 10(b) by securities purchasers.[13] Such a construction would overrule,

13. It is for this reason that we find the investors' reliance on *Herman & McLean v. Huddleston*, 459 U.S. 375 (1983), to be misplaced. In *Huddleston*, the Supreme Court found section 10(b) applicable to conduct also covered by section 11 of the 1933 Act, rejecting the contention that any overlap between the two provisions would be fatal to the viability of the section 10(b) claim. *Huddleston*, 459 U.S. at 382, 383. In *Huddleston*, the availability of a remedy under section 10(b) did not render section 11 superfluous because section 11, with its negligence standard of proof, remained available to the plaintiff who could not make a claim under section 10(b) for lack of the scienter element. Some overlap, limited to cases where scienter can be proven, is not inconsistent with the purposes of the securities act.

Yet here the investors propose not merely some overlap, but as the verdict clearly indicates, an application of section 12(2) which would render superfluous any claim for the same grievance under section 10(b) with its more stringent burdens

sub silencio, section 10(b) as a remedy for purchasers.

The different remedies available under section 12(2) and section 10(b), also indicate that section 12(2) should be restricted to initial distributions. Section 12(2) provides for rescissionary damages, *Pinter v. Dahl*, 486 U.S. 622, 641 n.18 (1988), and section 10(b) permits recovery only of actual damages, *see Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972). There is good reason why sellers in initial distributions should be liable for rescissionary damages. These sellers receive the full purchase price from the investors and are the investors' sole source of information concerning the value of the security. The same is not true of sellers in the aftermarket, such as Legg Mason, who receive only a commission and who are not the investors' sole source of information concerning the value of the stock.

These differing remedies are also entirely consistent with the legislative purpose of promoting full disclosure in securities distributions as well. Because misrepresentations in initial offerings can influence the purchase price of securities, rescissionary damages are appropriate to make an investor whole and deter any negligence on the part of a seller of batch offerings. Conversely, a misrepresentation by a broker (although perhaps not by others) in the secondary market is less likely to affect the price of a security and so should not be so heavily penalized. The difference between the "more pro-plaintiff oriented

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of proof. This would provide to purchasers of securities in secondary markets, a section 12(2) remedy to plaintiffs unable to prove section 10(b) elements of scienter, reliance and causation.

damages" under section 12(2) is illustrated clearly in this case where the investors prevailed only under their section 12(2) claim with its lesser proof requirements, yet were awarded potentially greater damages than those recoverable under section 10(b).[14] *See Hoxworth*, 903 F.2d at 203, 203 n.25 (contrasting damages under section 12(2) and section 10(b)). We are convinced that the different remedies available under section 10(b) and section 12(2) support restricting the application of section 12(2) to initial distributions.

In sum, the language and legislative history of section 12(2), as well as its relationships to sections 17(a) and 10(b) within the scheme of the 1933 and 1934 Acts, compel our conclusion that section 12(2) applies only to initial offerings and not to aftermarket trading.

IV.

Given our ruling concerning section 12(2) which will reverse the judgment in favor of the investors, we must now address the investors' cross-appeal in order to determine whether the investors are entitled to a new trial in which the jury is instructed on an agency theory of section 10(b) liability. The essence of this theory is that John Burke, as broker for the investors, was the agent of both Legg Mason and of his investor-clients. Legg Mason is subject to liability under section 10(b) of the 1934 Act if it misrepresented a material fact to Burke and Burke relied upon that

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14. Because the investors did not prevail on their section 10(b) claim, "actual" damages were not determined although Legg Mason did argue that independent market forces, such as the October 19, 1987, stock market crash, contributed to the investors' losses.

misrepresentation when inducing his investor-clients to purchase Wickes securities.

Before the district court, the investors requested the following jury instruction:

Misrepresentations Made To Agent

> Under the law, a broker is considered to be an agent of his or her customers. An agent is a person who has the power and authority to act on behalf of another person who is called a principal.
>
> The law also provides that if a third party makes misrepresentations to an agent, and the agent relies upon the false statements in entering into a transaction on behalf of his or her principal, then the principal can have the transaction set aside even though it was the agent who was actually defrauded.
>
> In this case, I charge you that as a matter of law John Burke was acting as the agent for all plaintiffs at the time they purchased securities in Wickes.
>
> If you find that Legg Mason made misrepresentations to John Burke, and that John Burke relied upon those misrepresentations in deciding whether to induce his customers to purchase Wickes, then you may find Legg Mason liable under Count I of the complaint even if you find that some of the plaintiffs did not in fact rely upon the misrepresentations regarding the book value of Wickes stock.

The district court, however, over the investors' timely objections, declined to submit this instruction to the jury.

We begin with the oft-stated principle that in order for a party to have its requested instruction given, there must be evidence in the record supporting its submission. *Edwards v. City of Philadelphia*, 860 F.2d 568, 575 n.7 (3d Cir. 1988); *DiRago v. American Export Lines, Inc.*, 636 F.2d 860, 867 (3d Cir. 1981). Additionally, a requested instruction reflecting a party's theory of its case must be legally correct. *Gander v. Mr. Steak of Sun Ray, Inc.*, 774 F.2d 920, 924 (8th Cir. 1985).

Nonetheless, there is a third step which may assist us in resolving this claim of error – assuming without deciding that the evidence adduced at trial supported the investors' requested instruction and that the requested instruction was legally correct, we turn to whether the district court's refusal to give the investors' requested agency instruction constituted harmless error.[15]

The essence of the investors' cross-appeal is that without the requested agency instruction the jury could have concluded that the investors' inability to establish direct personal communication with

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15. Rule 61 of the Federal Rules of Civil Procedure provides with respect to harmless error as follows:

> No error . . . in anything done or omitted by the court or by any of the parties is ground for . . . vacating, modifying or otherwise disturbing a judgment or order, unless refusal to take such action appears to the court inconsistent with substantial justice. The court at every stage of the proceeding must disregard any error or defect in the proceeding which does not affect the substantial rights of the parties.

Fed. R. Civ. P. 61. In making a non-constitutional "harmless error" determination, the court must have a sure conviction that the error did not prejudice a party, but it need not disprove every reasonable possibility of prejudice. *United States v. Jannotti*, 729 F.2d 213, 219-20 n.2 (3d Cir. 1984).

Batten precluded the imposition of liability under section 10(b). If, however, the district court *had* given the agency instruction, proof of direct reliance by the investors would not have been necessary because Burke testified that *he* had relied upon Batten's misrepresentations.

According to the uncontested jury instruction given with respect to section 10(b)[16], the investors were required to prove the following five elements in order to establish a section 10(b) violation:

> 1. Legg Mason used the mails or an instrumentality of interstate commerce, or a facility of a national securities exchange, in connection with the purchase or sale of securities;
>
> 2. In connection with such purchase or sale, Legg Mason made some untrue statements of material fact, or omitted to state a material fact necessary in order to make the statements which were made, in light of the circumstances under which they were made, not misleading;
>
> 3. Legg Mason acted with scienter;
>
> 4. The plaintiffs justifiably relied upon Legg Mason's conduct; and
>
> 5. The plaintiffs suffered damages as a result of Legg Mason's conduct.

With respect to this section 10(b) claim, the jury rendered a verdict in favor of Legg Mason and against the investors and John Burke, their broker. The verdict against John Burke indicates

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16. The jury instruction was given substantially in accordance with the instruction set forth in Devitt, Blackmar and Wolff, Federal Jury Practice and Instructions, Civil § 101.02, at 847-48 (1987).

that Burke failed to meet his burden of proof with respect to at least one of the five elements of the section 10(b) claim. Therefore, in light of the fact that Burke was not able to make out a successful section 10(b) cause of action against Legg Mason, we must determine whether the investors could possibly have met their burden under an agency theory.

We have reviewed each of the five section 10(b) elements and have assumed that each was the sole basis upon which the jury relied in rendering a verdict against Burke. We conclude that the investors would have necessarily failed in meeting their burden even under their agency theory.

By virtue of a stipulation, the first element of the investors' section 10(b) case was not at issue (that Legg Mason used the mails or an instrumentality of interstate commerce or a facility of a national securities exchange in connection with the purchase or sale of securities). If the jury found that the requirements of element two were not applicable to Legg Mason's conduct (no untrue statement or omission), it would necessarily have found for Legg Mason under the agency theory as well. If, in evaluating the third factor, the jury concluded that Legg Mason did not act with scienter, then an agency instruction would not have cured this defect. With respect to the fourth element, if the jury determined that Burke did not justifiably rely upon Legg Mason's conduct, there could have been no derivative reliance. Consequently, an agency instruction would have been of no benefit to the investors. Finally, if the jury concluded that Burke suffered no damages as a result of Legg Mason's conduct (the fifth element), an agency instruction could not have influenced the verdict.

Because we conclude that the agency theory could not possibly have provided an alternative basis for liability, the district court's failure to give an agency instruction was harmless error at most.

V.

For the reasons detailed above, we hold that the remedy provided by section 12(2) is limited to initial distributions. Furthermore, we find no reversible error in the district court's refusal to give the investors' requested agency instruction. Accordingly, we will reverse the judgment of the district court with respect to the section 12(2) count and remand for the entry of judgment for Legg Mason. With respect to the section 10(b) count, we will affirm the judgment in favor of Legg Mason.

A True Copy:
Teste:

Clerk of the United States Court of Appeals
for the Third Circuit

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

Nos. 90-1412 and 90-1427

BALLAY, ET AL
Appellants/Cross-Appellees

v.

LEGG MASON WOOD WALKER

SUR PETITION FOR REHEARING

PRESENT: SLOVITER, *Chief Judge,* BECKER, STAPLETON, MANSMANN, GREENBERG, HUTCHINSON, SCIRICA, COWEN, NYGAARD and ALITO, *Circuit Judges,* and DEBEVOISE, *District Judge.**

The petition for rehearing filed by appellants/cross-appellees in the above entitled case having been submitted to the judges who participated in the decision of this court and to all other available circuit judges of the circuit in regular active service, and no judge who concurred in the decision having asked for rehearing, and a majority of the circuit judges of the circuit in regular active service not having voted for rehearing by the court in banc, the petition for rehearing is denied.

BY THE COURT,

Carol Los Mansmann

Circuit Judge

MAR 21 1991

*Judge Debevoise voted only as to panel rehearing.

IN THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF PENNSYLVANIA

STEPHEN J. BALLAY, ET AL	:	C.A. NO. 88-6867
v.	:	
LEGG MASON WOOD WALKER, INC.	:	FILED DEC 21 1988

MEMORANDUM OPINION AND ORDER

WEINER, J. December 20, 1988

ENTERED: 12-21-88
CLERK OF COURT

This is an action brought by 41 individual plaintiffs who seek to recover losses they allegedly incurred in trading accounts they maintained with defendant Legg Mason Wood Walker, Inc. ("Legg Mason"). Specifically, plaintiffs contend that they purchased shares of stock in Wickes Companies, Inc. ("Wickes") based upon Legg Mason's false and misleading representations concerning the book value of Wickes' stock. Plaintiffs allege violations of Section 10(b) of the Securities Exchange Act of 1134 (Count I), Section 12(2) of the Securities Act of 1933 (Count II), Section 15 of the Securities Act of 1933 and Section 20 of the Securities Exchange Act of 1934 (Count III) and the common law (Count IV). Presently before the court is the motion of Legg Mason to (1) stay all proceedings and compel arbitration of plaintiffs' claims under the Securities Exchange Act of 1934 in Counts I and III and under the common law in Count IV, and (2) dismiss plaintiffs' claims under Section 12(2) and 15 of the Securities Act of 1933 set forth in Counts II and III of the complaint. For the reasons which follow, the motion is granted in part and denied in part.

MOTION TO COMPEL ARBITRATION

Prior to opening their accounts with Legg Mason, 16 of the 41 plaintiffs ("the 16 plaintiffs") signed a Customers Margin and Loan Consent and/or a Customer Option Agreement with Legg Mason. Included among these plaintiffs was John J. Burke, Jr. who, as an agent with Legg Mason, allegedly orally communicated false statements to plaintiffs concerning the book value of Wickes' securities. These agreements contained the following identical arbitration clause:

> In the event of a dispute or controversy between the parties to this Agreement involving the purchase or sale of any security, the handling of any funds or any other matter involving the handling of the account, I agree that the same shall be arbitrated through the arbitration facilities of the New York Stock Exchange, Inc, or the National Association of Securities Dealers, Inc. However, I am aware that this arbitration provision is not binding upon me in any dispute or controversy that arises under the federal securities laws, and, in such cases, I may seek resolution through litigation in the courts.

Legg Mason argues that under the terms of this arbitration clause the 16 plaintiffs who signed the margin and/or options agreements must submit their claims arising under the Securities Exchange Act of 1934 and under the common law to arbitration. Plaintiffs, on the other hand, point out that each arbitration clause provides that the "arbitration provision is not binding upon [plaintiffs] in any dispute or controversy that arises under the federal securities law and, in such cases [plaintiffs] may seek resolution through litigation in the courts." Legg Mason acknowledges this language but contends that the language is "merely a procedural formulation intended to advise customers that until the courts resolved the arbitrability of federal securities law

claims they may not have to arbitrate such claims." Defendant's Reply Brief at 2.

Before we begin our analysis, we note that the Supreme Court has determined that there is a strong presumption in favor of arbitration. *Mitsubishi Motors Corp. v. Soler Chrysler Plymouth,* 105 S.Ct. 3346 (1985); *Moses H. Cone Memorial Hospital vs. Mercury Const. Corp.,* 460 U.S. 1 (1983). This presumption arises under the Federal Arbitration Act, 9 U.S.C. §1, *et seq.* Section 2 of the Federal Arbitration Act provides in part:

> [a] written provision in any . . . contract evidencing a transaction involving commerce to settle by arbitration a controversy thereafter arising out of such contract or transaction, or the refusal to perform the whole or any part thereof, or an agreement in writing to submit to arbitration an existing controversy rising out of such contract . . . shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract.

9 U.S.C. §2 (1970). In *Moses H. Cone Memorial Hospital, supra,* the Supreme Court described this presumption by stating "[t]he Arbitration Act establishes that, as a matter of federal law, any doubts concerning the scope of arbitrable issues should be resolved in favor of arbitration." 460 U.S. at 24-25. With these principles in mind, we turn to the merits of Legg Mason's motion to compel arbitration.

As noted above, Legg Mason contends that the 16 plaintiffs who signed the margin and/or option agreements must submit their claims arising under state law and the Securities Exchange Act of 1934 to arbitration. There can be no question that the 16 plaintiffs must submit their common law claims to arbitration. In *Dean Witter Reynolds v. Byrd,* 470 U.S. 213,221 (1985), the Supreme Court specifically concluded that the Federal Arbitration Act leaves no place for discretion by a district

court and that compelling arbitration of state-law claims "protects the contractual rights of the parties and their rights under the Arbitration Act." Therefore, the 16 plaintiffs' common law claims must be arbitrated.

It would also appear that the 16 plaintiffs must arbitrate their federal securities claims brought under Sections 10(b) and 20 of the Securities Exchange Act of 1934. That is because the Supreme Court in *Shearson/ American Express, Inc. v. McMahon,* 107 S.Ct. 2332 (1987), established the arbitrability of Securities Exchange Act claims.

Plaintiffs contend, however, that despite the *McMahon* decision, they cannot be compelled to arbitrate any of the federal securities claims. In so arguing, plaintiffs direct our attention to the final sentence contained in each of the arbitration agreements which provides that the "arbitration provision is not binding upon [plaintiffs] in any dispute or controversy which arises under the federal securities laws and, in such cases, [plaintiffs] may seek resolution through litigation in the courts." As will be seen, however, this sentence was prescribed by S.E.C. Rule 15c2-2, 17 C.F.R. §240.15c2-2 (1987).

At the time when the Securities Exchange Commission ("SEC") promulgated Rule 15c2-2 (SEC Release No. 34-20397, effective December 28, 1983), courts were not only following the holding of *Wilko v. Swan,* 346 U.S. 427 (1953) that claims arising under the Securities Act of 1933 were not arbitrable but were also extending *Wilko's* holding to claims arising under the Securities Exchange Act of 1934 as well. As a result, the SEC promulgated Rule 15c2-2, the purpose of which was to ensure that public customers signing broker-dealer customer agreements would not be misled as to the enforceability of predispute arbitration clauses. *See* 48 Fed.Reg. 53404 (1983). Specifically, Rule 15c2- 2(a) provided:

> It shall be a fraudulent, manipulative or deceptive act or practice for a broker or dealer to enter into an

> agreement with any public customer which purports to bind the customer to the arbitration of future disputes between them arising under the Federal Securities laws, or to have in effect such an agreement, pursuant to which it effects transactions with or for a customer.

17 C.F.R. §140.15c2-2(a). Consequently, the SEC in subsection (b) OF Rule 15c2-2 required brokers to advise their customers of their rights with the following language:

> Although you have signed the customer agreement with [FIRM NAME] that states that you are required to arbitrate any future dispute or controversy that may rise between us, you are not required to arbitrate any dispute or controversy that arises under the Federal Securities Laws but instead can resolve any such dispute or controversy through litigation in the courts.

17 C.F.R. §240.15c2-2(b). The vast majority of the courts which have interpreted Rule 15c2-2 and arbitration agreements drafted to comply with that Rule have held that this provision "merely serves to guarantee that potential plaintiffs receive notice that an agreement to arbitrate does not override existing federal laws limiting the scope of possible litigation; it does not create, nor does it preserve rights to litigate in federal courts." *Finkle and Ross v. A. G. Becker Paribas, Inc.,* 622 F.Supp. 1505, 1510 (S.D.N.Y. 1985); *see also McCowan v. Dean Witter Reynolds, Inc.,* 682 F.Supp. 741, 743 (S.D.N.Y. 1987); *Shotto v. Laub,* 632 F.Supp. 516, 527 (D.Md. 1986).[1] Moreover, in light of the Supreme Court's decision in *McMahon, supra,* which established the arbitrability of Securities Exchange Act claims, the SEC revoked Rule 15c2-2 on the ground that it is "no longer appropriate or accurate." Consequently, we find

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1. Plaintiffs' attempt to distinguish these cases is unpersuasive.

that the final sentence contained in each of the arbitration agreements did not "act substantively to prevent arbitration of all federal securities claims." *Shotto, supra.* Therefore, the 16 plaintiffs must arbitrate their 1934 Act claims in accordance with *McMahon* notwithstanding the inclusion of the Rule 15c2-2 language in Legg Mason's customer agreement.[2]

MOTION TO DISMISS

Legg Mason also moves this court to dismiss plaintiffs' claims under Sections 12(2) and 15 of the Securities Act of 1933.[3] Section 12(2) imposes liability on persons who offer or sell securities by means of any prospectus or oral statement containing material misrepresentations or omissions; the statute provides that such a person shall be liable "to the person purchasing such security from him" for recision or, if the plaintiff has sold the security, for damages. *See* 15 U.S.C. §77 (2). The United States Court of Appeals for the Third Circuit has held that Section 12 is designed solely as a vehicle for a purchaser against his immediate seller. *Collins v. Signetics Corp.,* 605 F.2d 110, 113 (3d Cir. 1979). *See also*

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2. Under the law of the Third Circuit, the 16 plaintiffs' federal securities claims brought under Sections 12(2) and 15 of the Securities Act of 1933 are not subject to arbitration. *Osterneck v. Merrill Lynch, Pierce, Fenner and Smith, Inc.,* 841 F.2d 508, 512 (3d Cir. 1988) ("As long as Wilko [v. Swan, 346 U.S. 427 (1953)] stands in the Supreme Court, agreements to arbitrate claims under the Securities Act of 1933 will remain unenforceable. . .") Although we agree with the reasoning of the United States Court of Appeals for the Fifth Circuit in *Rodriguez De Quijas v. Shearson/American Express, Inc.,* 845 F.2d 1296 (5th Cir. 1988) which interpreted *McMahon, supra,* as providing for the arbitrability of Securities Act claims notwithstanding the earlier precedent of *Wilko, supra,* we are bound by the law of the Third Circuit.

3. Although Legg Mason has asked this court to dismiss plaintiffs' claims under Section 15 of the Securities Act of 1933, Legg Mason does not address this issue anywhere in its Memorandum of Law or Reply Brief. We, therefore, will not dismiss plaintiffs' Section 15 claims.

Kramer v. Scientific Control Corp., 452 F.Supp., 812, 814 (E.D. Pa. 1978). Pursuant to this authority, Legg Mason contends that since plaintiffs have failed to allege strict privity between the plaintiffs and Legg Mason and have failed to allege that Legg Mason had control over the actual seller, plaintiffs' claims under Section 12(2) must be dismissed. We do not agree.

The Supreme Court recently addressed the meaning of the words "[a]ny person who . . . offers or sells a security" as used in Section 12(1) of the Securities Act of 1933. *See Pinter v. Dahl,* 108 S.Ct. 2063, 2075-76 (1988). In *Pinter,* the Court held that Section 12(1) "contemplates a buyer-seller relationship not unlike traditional contractual privity," 108 S.Ct. at 2076, but its scope is not "restricted to those who pass title," *id.* Rather, since "solicitation is the stage at which an investor is most likely to be injured," id. at 2078, the term "seller" must include the person "who successfully solicits the purchase motivated at least in part by a desire to serve his own financial interests or those of the securities owner," *id.* at 2079. The *Pinter* court specifically stated that such a person would include a broker, *id.* In reaching this definition, the Supreme Court first noted that the Third Circuit in *Collins, supra,* as well as other courts and commentators had concluded that the purchase requirement set forth in Section 12(1) "necessarily restricts Section primary liability to the owner of the security." *Pinter, supra,* at 2076. In rejecting the *Collins* notion that Section 12(1) requires privity between the statutory seller and buyer, the Supreme Court stated that:

> The applicability of Section 12 to brokers and others who solicit securities purchases has been recognized frequently since the passage of the Securities Act. It has long been "quite clear," that when a broker acting as agent of one of the principals to the transaction solicits a purchase, he is a person from

> whom the buyer purchases within the meaning of Section 12 and therefore liable as a statutory seller.

id at 2078.

Although the Supreme Court did not "take a position on" the scope of a "seller" for purposes of Section 12(2), 108 S.Ct. at 2076 n. 20, most authorities have held that the language of Sections 12(1) and 12(2) is identical in meaning. *See e.g., Pharo v. Smith,* 621 F.2d 656, 665-668, and nn. 6-8 (5th Cir. 1980); Schneider, Section 12 of the Securities Act of 1933: The Privity Requirement in the Contemporary Securities Law Perspective, 51 Tenn.L.Rev. 235, 261, and nn. 144 and 145 (1984). *See also Schillner v. H. Vaughan Clarke and Co.,* 134 F.2d 875, 878 (2d Cir. 1943) ("Clearly the word [sell] has the same meaning in subdivision (2) as in subdivision (1) of section 12"). Given this line of authority, plaintiffs aptly observe that for this court "[t]o hold that the purchase requirement under Section 12(2) limits the class of defendants to those individuals with whom the plaintiff is in strict privity, yet discard that requirement in a case prosecuted under Section 12(1), would give rise to an absurd statutory inconsistency." Memorandum in Opposition to Defendant's Motion to Stay all Proceedings and Compel Arbitration and to Dismiss Plaintiffs' Complaint insofar as it States Claims Under Section 12(2) of the 1933 Securities Act at 16. Moreover, since the Supreme Court decided *Pinto,* at least two courts have applied the *Pinter* definition of a "seller" under Section 12(1) to Section 12(2). *See e.g., Capri v. Murphy,* 856 F.2d 473, 478 (2d Cir. 1988); *In re Worlds of Wonder Securities Litigation,* 694 F.Supp. 1434-35 (N.D. Cal. 1988). For the foregoing reasons, we shall consider plaintiffs' Section 12(2) claim in light of *Pinter.*[4]

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4. Since the Supreme Court did not "take a position on" the scope of a "seller" for purposes of Section 12(2), we are still effectively bound by the Third Circuit's strict privity requirement as set forth in *Collins, supra.* However, we believe that for us to ignore

As noted above, *Pinter* defined a "seller" as one "who successfully solicits the purchase motivated at least in part by a desire to serve his own financial interests or those of the securities owner" *Pinter* at 2079. The *Pinter* Court specifically stated that such a person would include a broker *id.* In their complaint plaintiffs allege that Legg Mason, a brokerage firm, "solicited each plaintiff's purchase of stock in Wickes" by means of false and misleading oral communications. Complaint at paragraphs 61, 63. Based on those allegations, the court finds that plaintiffs have sufficiently alleged that Legg Mason was a seller within the meaning of Section 12(2).

Legg Mason also argues that Section 12(2) is only designed to prohibit misrepresentations and omissions which accompany an initial offering of stock. This argument is based on the premise that the Securities Act of 1933 is a narrow statute chiefly concerned with disclosure and fraud in connection with *initial* public offerings of securities and that Congress waited until the Securities Exchange Act of 1934 to regulate abuses in the trading of securities in the "aftermarket." As Legg Mason's alleged fraud did not involve a new offering, Legg Mason contends that plaintiffs cannot state a claim under Section 12(2) of the 1933 Act. Again, we do not agree.

In the first instance, we note that there is no language in Section 12(2) itself which would limit its application to fraud in connection with initial distribution of securities. Moreover, although the Supreme court has specifically stated that the "1933 Act was primarily concerned with the regulation of new offerings," *United States v. Naftalin,* 441 U.S. 768, 777-78 (1979), the *Naftalin* Court also found that the "antifraud prohibition

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NOTES *(Continued)*

the prevailing trend of the elimination of the strict privity requirement under Section 12 of the 1933 Act and follow the holding of a case (*Collins*) the reasoning behind which has been undermined by the Supreme Court, would be inappropriate.

of Section 17(a) [of the 1933 Act] was meant as a major departure from that limitation. Unlike much of the rest of the Act, it was intended to cover any fraudulent scheme in an offer or sale of securities, whether in the court of an initial distribution or in the course of ordinary market trading." *id.* Although the *Naftalin* Court's finding was limited to the antifraud prohibition of Section 17(a) of the 1933 Act, Section 12(2) comprises the other antifraud provision of the 1933 Act. *Wilko v. Swan,* 127 F.Supp. 55, 58 (S.D.N.Y. 1955). Certainly, the Supreme Court's finding that the antifraud prohibition of Section 17(a) "was intended to cover any fraudulent scheme in an offer or sale of securities, whether in the course of an initial distribution or in the court of ordinary market trading" should apply to the other antifraud provision of the 1933 Act as well. After all, it has been noted that Sections 17 and 12(2) serve the dual purpose of "render[ing] unlawful and authoriz[ing] civil recovery for fraud and misrepresentation in the sale of securities. . ." *Wilko v. Swan, supra.* In addition, the court is aware of at least three cases in which plaintiffs were allowed to proceed with their Section 12(2) claims despite the fact that the alleged fraud involved trades in outstanding securities. *See, e.g., Quincy Co-op Bank v. A. G. Edwards and Sons, Inc.,* 655 F.Supp. 78, 81 (D. Mass. 1986); *Monetary Management Group v. Kidder Peabody Co.,* 615 F.Supp. 1217, 1219-20 (E.D. Mo. 1985); *Rogers v. Lehman Brothers Kuhn Loeb, Inc.,* 604 F.Supp. 222, 223-24 (S.D Ohio 1984). We, therefore, shall allow all of the plaintiffs to proceed to trial with their Section 12(2) claims under the 1933 Act.

IN THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF PENNSYLVANIA

STEPHEN J. BALLAY, ET AL	:	
	:	
v.	:	C.A. NO. 88-6867
	:	
LEGG MASON WOOD WALKER, INC.	:	

ORDER

The motion of defendant, Legg Mason Wood Walker, Inc., to stay all proceedings and compel arbitration and to dismiss plaintiffs' claims under the Securities Act of 1933 is GRANTED in part and DENIED in part.

The 16 plaintiffs, including John J. Burke, Jr., who signed a Customer's Margin and Loan Consent Agreement and/or Customer Option Agreement with Legg Mason Wood Walker, Inc. shall promptly submit their claims under Sections 10 and 20 of the Securities Exchange Act of 1934 and their claims under the common law to arbitration in accordance with the terms of the above written agreements with Legg Mason Wood Walker, Inc.

Following arbitration of the above claims; trial of the claims of the remaining 25 plaintiffs who did not sign a Customer's Margin and Loan Consent Agreement and/or Customer Option Agreement arising under Sections 10 and 20 of the Securities Exchange Act of 1934 and under the common law as well as the claims of all 41 plaintiffs arising under Sections 12(2) and 15 of the Securities Act of 1933 shall commence on Monday, January 23, 1988 at 9:30 a.m., in Courtroom 6B, United States Courthouse, 601 Market Street, Philadelphia, Pennsylvania.

IT IS SO ORDERED.

CHARLES R. WEINER

IN THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF PENNSYLVANIA

STEPHEN J. BALLAY, ET AL	:	
	:	
v.	:	C.A. NO. 88-6867
	:	
LEGG MASON WOOD WALKER, INC.	:	

MEMORANDUM OPINION AND ORDER

WEINER, J. DECEMBER 27, 1989

Plaintiffs, forty-one investing customers who allegedly suffered losses as a result of misrepresentations by defendant concerning the book value of certain securities purchased by plaintiffs, brought this action charging defendant with violations of sections 10(b) and 20 of the Securities Exchange Act of 1934, 15 U.S.C. §§78j(b) and 78t (Exchange Act), of section 12(2) and 15 of the Securities Act of 1933, and of the common law. When they opened their trading accounts with defendant, sixteen of the forty-one plaintiffs signed customer agreements that contained an arbitration provision. The provision stated that disputes arising out of the purchase or sale of securities would be arbitrated, but added the qualification that disputes arising "under the federal securities laws" need not be arbitrated but could be litigated in the courts. On the basis of this arbitration provision, defendant filed a motion to stay proceedings and to compel arbitration of the claims of the sixteen plaintiffs who signed the customer agreements and to dismiss plaintiffs' claims under section 12(2) of the Securities Act of 1933. With regard to the latter, defendant contended that it was not a "seller" of securities for purposes of section 12(2) and that section 12(2) does not govern transactions in the secondary market as opposed to an initial public offering. In a Memorandum Opinion and Order dated December 20, 1988, we partially granted and partially denied defendant's motion. With regard to the part of the motion seeking to compel

arbitration, we held that the common law claims and Exchange Act claims of the sixteen plaintiffs who signed customer agreements had to be arbitrated, but we refused to compel arbitration of the common law and Exchange Act claims of the twenty-five plaintiffs who did not sign customer agreements nor did we compel arbitration of the Securities Act claims of all forty-one plaintiffs. With regard to the part of the motion seeking to dismiss plaintiffs' claims under section 12(2) of the Securities Act of 1933, we found that defendant was a "seller" within the meaning of section 12(2) and that section 12(2) does indeed govern transactions in the secondary market. Defendant subsequently took an interlocutory appeal from the portion of our Order denying its motion to compel arbitration of plaintiffs' claims arising under the Securities Act of 1933. While the defendant's appeal was pending, the portion of the case not sent to arbitration pursuant to the customer agreements was listed for trial. The case was bifurcated and the issue of liability was tried to the court sitting with a jury. After a one week trial, the jury returned a verdict in favor of the defendant and against the twenty-five plaintiffs who did not sign the customer agreements on the plaintiffs' claims under section 10(b) of the Securities Exchange Act of 1934. At the same time, however, the jury found in favor of the forty-one plaintiffs and against the defendant on the plaintiffs' claims under section 12(2) of the Securities Act of 1933. The court subsequently entered judgment in favor of the plaintiffs on the section 12(2) claims. The court postponed the damages portion of the trial, pending a decision by the United States Court of Appeals for the Third Circuit on the arbitrability of the claims of the sixteen plaintiffs who did not sign customer agreements under the Securities Act of 1933.[1] Meanwhile, the parties not only filed

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1. While the plaintiffs' interlocutory appeal was pending before the Court of Appeals, the Supreme Court decided the case of *Rodriguez De Quijas v. Shearson/American Express, Inc.*, 57

a litany of post-trial motions, but repeatedly bombarded the court with supplement upon supplement in support of these motions. Specifically, the defendant filed a motion for judgment notwithstanding the verdict or, in the alternative, for a new trial on the section 12(2) claims and a motion for "summary judgment on the record" while the plaintiffs filed a motion for summary judgment on damages. While the court was considering these motions, the Court of Appeals affirmed the part of our Order of December 20, 1988, denying defendant's motion to compel arbitration of plaintiffs' claims arising under the Securities Act of 1933. In view of the parties' indications that they wished to work out an amicable joint settlement of this and a similar pending matter before this court, *Kahn v. Legg Mason Wood Walker, Inc.*, C.A. No. 89-4419, the court continued to postpone any trial on the damage portion of this case. As all settlement negotiations appear to have been unsuccessful, we now turn to the parties' post-trial motions.

In its motion for summary judgment on the record and in its motion for judgment n.o.v. or, in the alternative, new trial, the defendant raises two principal legal arguments[2] which incidentally are the same two legal

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U.S.L.W. 4539 (1989), in which it upheld a predispute agreement to arbitrate claims under the Securities Act of 1933. In light of the Supreme Court's decision, we believed the Court of Appeals would reverse the portion of our Order of December 20, 1988, refusing to compel arbitration of the Securities Act claims of the sixteen plaintiffs who had signed customer agreements. The court thought it would be a waste of time and effort to begin the damage phase of the trial only to later have the Court of Appeals reverse our ruling and direct the sixteen plaintiffs who had signed customer agreements to proceed to arbitration with their Securities Act claims. As it turned out, however, the Court of Appeals affirmed our ruling, finding that the customer agreement in the case *sub judice*, unlike that in *Rodriguez de Quijas*, explicitly excepted from arbitration claims arising under federal securities law.

2. In addition to these two principal legal arguments, the defendant raised a number of other legal and evidentiary points in its original motion for judgment n.o.v. or new trial, including

arguments it raised in its original motion to dismiss the section 12(2) claims; that is that the defendant is not a seller for purposes of section 12(2) and that section 12(2) does not govern transactions in the secondary market. We will address these claims in turn.

MEANING OF "SELLER" UNDER §12(2)

Section 12(2) of the Securities Act provides that any person who offers or sells a security by means of a prospectus or oral communication that makes misstatements or omissions of material fact "shall be liable to the person purchasing such a security from him." 15 U.S.C. §77 (2) (1988). Relying on the decision of the United States Court of Appeals for the Third Circuit in *Collins v. Signetics, Corp.*, 605 F.2d 110 (3d Cir. 1979), the defendant contends that the plaintiffs have failed to state

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NOTES *(Continued)*

alleged errors by the court both during the trial and in its charge to the jury. Although the defendant repeatedly advised the court in its supplemental filings that it "planned to address each of the legal and evidentiary points raised in its post-trial motions in a single, comprehensive brief to be filed after review of the trial transcript," the only brief defendant filed with any references to the transcript whatsoever is its second supplemental memorandum of law in support of post-trial motions. However, in that brief the only point defendant raised in addition to the two principal legal arguments mentioned above, is that the plaintiff did not prove at trial that defendant made any material misrepresentations or omissions to the plaintiffs, a necessary requirement under section 12(2). Apparently defendant has chosen not to pursue the other legal and evidentiary points it asserted in its original motion for judgment n.o.v. or new trial. Accordingly, we will deem these arguments as waived. In any event, the court has conducted its own review of the evidence presented at trial and the court's charge to the jury and finds that the jury's verdict comported with all the evidence adduced at trial and that the court carefully and correctly charged the jury on the relevant legal issues. With regard to defendant's argument that plaintiffs failed to establish materiality under section 12(2), we can glean no reason from our review of the Notes of Testimony to disturb the jury's finding that defendant's misrepresentations concerning the book value of a share of Wickes stock exclusive of goodwill were material.

a claim against the defendant because under *Collins,* only the *immediate* seller of securities is liable to the purchaser for violations of §12(2).

In our Memorandum Opinion and Order of December 20, 1989, we noted that since the Third Circuit's decision in *Collins,* the Supreme Court, in *Pinter v. Dahl,* 108 S.Ct. 2063 (1988), considered the scope of the term "seller" in the context of section 12(1) of the Securities Act of 1933. In *Pinter,* the Court reasoned that because "solicitation is the stage at which an investor is most likely to be injured," *id.* at 2078, the term "seller" must include the person "who successfully solicits the purchase motivated at least in part by a desire to serve his own financial interests or those of the securities owner," *id.* at 2079. The *Pinter* court specifically stated that such a person would include a broker, *id.* Although the Supreme Court did not "take a position on" the scope of a "seller" for purposes of section 12(2), *id.* at 2076, n. 20, we noted that most authorities have held that the language of sections 12(1) and 12(2) is identical in meaning. Therefore, although we were still effectively bound by the Third Circuit's strict privity requirement as set forth in *Collins, supra,* we elected to follow the prevailing trend of the elimination of the strict privity requirement under section 12 as enunciated in *Pinter.* Noting that plaintiffs' complaint alleged that defendant, a brokerage firm, "solicited each plaintiff's purchase of stock in Wickes" by means of false and misleading oral communications, we found that plaintiffs had sufficiently alleged that defendant was a seller within the meaning of section 12(2). In its motions for summary judgment on the record and for judgment n.o.v. or new trial, however, defendant continues to insist that the *Pinter* analysis is limited to claims under section 12(1) and, as a result, we are still bound by the Third Circuit's decision in *Collins.* Fortunately, the United States Court of Appeals for the Third Circuit has just definitively resolved the issue. In *In re Craftmatic Securities Litigation v. Kraftshow, et al,* No. 89-1192

(3d Cir. November 29, 1989), the Court of Appeals adopted the *Pinter* analysis and held that "liability ander section 12(2) extends not only to those who pass title to the purchaser, but also to those who successfully solicit the purchase, motivated by their own or the securities owner's financial interests." Accordingly, defendant's contention that it is not a "seller" under section 12(2) must fail.

SCOPE OF SECTION 12(2) LIABILITY

Defendant also argues in its motion for summary judgment on the record and in its motion for judgment n.o.v. or new trial, that section 12(2) applies only to an initial distribution of securities and not to subsequent trading. Section 12(2) imposes liability on a "person who . . . offers or sells a security . . . by means of a prospectus or oral communication." According to defendants, "prospectus or oral communication" refers to a prospectus, registration statement, or other communication related to a batch offering of securities, not to subsequent trading.[3]

Unfortunately, unlike the privity issue we just discussed, there has been no decision by the United States Court of Appeals for the Third Circuit or any other Court of Appeals for that matter to guide us on this question which is of considerable current interest in the marketplace. As the following citations demonstrate, there is not only a conflict between the districts but also a conflict between judges within the same district on this issue: *See McCowen v. Dean Witter Reynolds, Inc.*, [Current Binder] Fed.Sec.L.Rep. (CCH) para. 94, 423 at 92,726-727 (S.D.N.Y. April 11, 1989); *Strong v. Paine Webber, Inc.*, 700 F.Supp. 4, 5 (S.D.N.Y. 1988); *SSH Co., Ltd. v. Shearson Lehman Bros., Inc.*, 678 F.Supp. 1055, 1059 (S.D.N.Y. 1987); *Ackerman v. Clinical Data, Inc.*, [1985-86 Transfer Binder] Fed.Sec.L.Rep. (CCH)

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3. The parties do not dispute that the transactions in the case *sub judice* occurred in the secondary market.

para. 92,207 at 91,568 n. 3 (S.D.N.Y. July 8, 1985); *Klein v. Commuter Devices, Inc.*, 591 F.Supp. 270, 277-78 (S.D.N.Y. 1984); *Gross v. Diversified Mortgage Investors*, 431 F.Supp. 1080, 1095 (S.D.N.Y. 1977); *aff'd mem.*, 636 F.2d 1201 (2d Cir. 1980); *Bresson v. Thomson McKinnon Securities, Inc.*, 641 F.Supp. 338, 342 (S.D.N.Y. 1976); *Panek v. Boquez*, No. 88-3050 (D.N.J. March 10, 1989) (available on Lexis); *Cheltenham Bank v. Drexel Burnham Lambert, Inc.*, [Current Binder] Fed.Sec.L. Rep. (CCH) para. 94,391 at 92,542 (E.D.N.C. March 15, 1989); *Leonard v. Shearson Lehman/American Express, Inc.*, 687 F.Supp. 177, 179-80 (E.D. Pa. 1988); *First Union Brokerage v. Milos*, No. 87-6981 (S.D. Fla. May 12, 1989) (available on Westlaw, Lexis); *Ralph v. Prudential-Bache Securities, Inc.*, 692 G.Supp. 1322, 1325 (S.D. Fla. 1988); *Mix v. E. F. Hutton and Co., Inc.*, No. 85-3108, 3109, 3110 (D.D.C. September 5, 1989) (available on Lexis). (All these cases holding that section 12(2), and the 1933 Act in general, do not cover post-distribution trading of securities or trading in "secondary" markets). But see *Wilko v. Swan*, 127 F.Supp. 55, 58-60 (S.D.N.Y. 1955); *Scotch v. Mosely, Hallgarten, Estabrook and Weeden, Inc.*, 709 F.Supp. 95, 97-98 (M.D. Pa. 1988); *Hoxworth, et al v. Blinder Robinson and Co., Inc.*, Nos. 88-0285, 0286, 0307 (E.D. Pa. May 23, 1989) (available on Lexis); *Elysian Federal Savings Bank v. First Interregional Equity Corp.*, 713 F.Supp. 737, 747-51 (D. N.J. 1989) (All these cases holding that section 12(2) and the 1933 Act in general, do cover post-distribution trading of securities or trading in "secondary" markets). Indeed, the district courts have even split in interpreting the leading text in this area of the law. *See* L. Loss, *Fundamentals of Securities Regulation* (1983). Many of the courts which have held that section 12(2), and the 1933 Act in general, do not cover post-distribution trading of securities or trading in "secondary" markets have cited Professor Loss' text for that proposition. However, this court in *Hoxworth, supra,* noted that:

> . . . Professor Loss merely states that the Securities Act of 1933 as a whole is primarily concerned with initial offerings. He does not say that not one section of it applies to subsequent trading. When Professor Loss does take up Section 12(2) specifically he states: "To start with what is clearest, the section applies to all sales of securities . . ." [citation omitted]

Hoxworth, supra at 25.

In our Memorandum Opinion and Order of December 20, 1988, we resolved the issue as follows:

> Legg Mason also argues that Section 12(2) is only designed to prohibit misrepresentations and omissions which accompany an initial offering of stock. This argument is based on the premise that the Securities Act of 1933 is a narrow statute chiefly concerned with disclosure and fraud in connection with initial public offerings of securities and that Congress waited until the Securities Exchange Act of 1934 to regulate abuses in the trading of securities in the "aftermarket." . . . Again, we do not agree. In the first instance, we note that ***there is no language in Section 12(2) itself which would limit its application to fraud in connection with initial distribution of securities.*** Moreover, although the Supreme Court has specifically stated that the "1933 Act was primarily concerned with the regulation of new offerings," *United States v. Naftalin,* 441 U.S. 768, 777-778 [99 S.Ct. 2077, 2083-2084, 60 L.Ed.2d 624) (1979), the Naftalin Court also found that the "antifraud prohibition of Section 17(a) [of the 1933 Act] was meant as a major departure from that limitation. Unlike much of the rest of the Act, it was intended to cover any fraudulent scheme in an offer or sale of securities, whether in the court (sic) of an initial distribution or in the course of ordinary market trading." *Id.* Although the Naftalin Court's finding was limited to the antifraud prohibition of Section 17(a) of the

> 1933 Act, Section 12(2) comprises the other anti-fraud provision of the 1933 Act. *Wilko v. Swan,* 127 F.Supp. 55, 58 (S.D.N.Y. 1955). *Certainly, the Supreme Court's finding that the antifraud prohibition of Section 17(a) "was intended to cover any fraudulent scheme in an offer or sale of securities, whether in the course of an initial distribution or in the court (sic) of ordinary market trading" should apply to the other antifraud provision of the 1933 Act as well.* After all, it has been noted that Sections 17 and 12(2) serve the dual purpose of "render[ing] unlawful and authoriz[ing] civil recovery for fraud and misrepresentation in the sale of securities . . ." *Wilko v. Swan, supra.* (emphasis added)

However, the district courts have even split in following this analysis. *Compare Elysian, supra* ("It has not been compellingly demonstrated why the reasoning in *Ballay* should be ignored") with *Mix, supra* ("The Court, therefore, rejects the reasoning of those courts that have cited *Naftalin* and Section 17(a) as supporting an equally expansive interpretation of Section 12(2). See *Scotch,* 707 F.Supp. at 98 and n. 3; *Ballay,* slip op. at . . . .")

Like the *Elysian* court, we see no compelling reason why we should depart from our earlier analysis in Ballay, especially in light of the recent decision of the United States Court of Appeals for the Third Circuit in *In re Data Access Systems Securities Litigation,* 843 F.2d 1537 (3d Cir. 1988) (en banc), *cert. denied sub nom., Vitiello v. I. Kahlawsky and Co.,* 109 S.Ct. 131 (1988), wherein the Court of Appeals emphasized the broad remedial purposes of the Securities Act (to "provide full and fair disclosure" in connection with interstate securities sales). We also note that the district courts which have reached our conclusion are all within this circuit. Accordingly, we once again hold that section 12(2) applies to transactions in the secondary market.

CERTIFICATION FOR APPEAL

This court may certify an otherwise unappealable interlocutory order if "such order involves a controlling question of law as to which there is substantial ground for difference of opinion and that an immediate appeal from the order may materially advance the ultimate termination of the litigation . . ." 28 U.S.C. §1292(b). Our Court of Appeals instructs that the certification provision is to be used sparingly. *Spork v. Peil,* 759 F.2d 312, 315 n. 4, *cert. denied,* __ U.S. __, 106 S.Ct. 232, 88 L.Ed.2d 120 (1985), *quoting Milbert v. Bison Laboratories,* 160 F.2d 431, 433 (3d Cir. 1958). Section 1292(b) "is to be used only in exceptional cases where an intermediate appeal may avoid protracted and expensive litigation and is not intended to open the floodgates to a vast number of appeals from interlocutory orders in ordinary litigation." *Milbert, supra,* 260 F.2d at 433. "A controlling question of law must encompass at the very least every order which, if erroneous, would be reversible error on final appeal." *Katz v. Carte Blanche Corp.,* 496 F. 2d 747, 755 (3d Cir.), *cert. denied,* 419 U.S. 885 (1974).

The court believes that much potentially otherwise wasted time and expense could be saved if the Court of Appeals (in its choosing, of course) heard argument and made a definitive ruling at this stage of the proceedings on whether section 12(2) of the Securities Act can be applied to fraud occurring in the secondary markets.

The court believes that all the criteria for certification under 28 U.S.C. §1292(b) have been met. The question of whether section 12(2) can be applied to fraud occurring in the secondary markets is not only a controlling question of law but is indeed the central issue in this case, having produced a seemingly infinite number of briefs by the parties. As indicated by the district court citations above, if ever there was a question of law to which there is substantial ground for difference of opinion, it is the question of whether section 12(2)

can be applied to transactions in the secondary market. Most significant, however, is that an immediate appeal would materially advance the ultimate termination of the litigation. The only claim on which plaintiffs prevailed at trial was the section 12(2) claim. It would be a waste of time and expense for the court to now conduct a lengthy damages trial on the section 12(2) claim as it appears will be necessary,[4] only to have the Court of Appeals find after the damage verdict on the inevitable appeal which would follow, that section 12(2) does not cover transactions in the secondary market. A definitive ruling by the Court of Appeals at this stage would ultimately lead to the termination of this litigation. Were the court of Appeals to reverse our ruling and find that section 12(2) does not cover transactions in the secondary market, we would promptly vacate the judgment we entered in favor of the plaintiffs on the section 12(2) claims, and there would be no need to conduct the damages phase of this case. Were the Court of Appeals to affirm our ruling, the damages phase of the case could be expeditiously listed for trial.

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4. Plaintiffs base their motion for summary judgment on damages on the fact that, during the liability phase of the trial, they introduced into evidence without objection a chart reflecting the names of the individual claimants, the time period during which each plaintiff invested in the securities of Wickes, the total dollar amount invested, the date upon which the plaintiffs ultimately liquidated their positions in Wickes, and the dollar amount realized at liquidation. As a result, the plaintiffs contend that "fixing the measure of damages to which plaintiffs are entitled is an exercise in mathematics rather than a factual issue requiring jury deliberation." We do not agree. Although the chart was admitted into evidence without objection, the record reveals that defense counsel, both prior to and during trial, informed plaintiff's counsel that they could not stipulate to the accuracy of all the figures on the chart and indeed intended to challenge the accuracy of these figures during the damages portion of the trial. In addition, contrary to the plaintiffs' assertions, it is for the jury to determine whether or not the plaintiffs acted reasonably to mitigate their damages. Accordingly, we find that enough of a factual dispute exists as to the proper measure of damages, so that the issue must be resolved by the jury.

We also note that a decision from the Court of Appeals would also materially advance the ultimate termination of a nearly identical matter before this court, *Kahn, et al v. Legg Mason Wood Walker, Inc.,* C.A. No. 89-4419. In *Kahn,* the plaintiffs' attorneys, who were also before this court in *Ballay,* have asserted, *inter alia,* the same section 12(2) claims as the plaintiffs did in *Ballay* against the same defendant. The parties are currently proceeding with discovery and the plaintiffs have filed a motion for class certification on, *inter alia,* the section 12(2) claims. A definitive ruling from the Court of Appeals on the section 12(2) issue would guide the court in disposing of the *Kahn* matter and perhaps save the parties from engaging in unnecessary discovery and trial.

Finally, we note that as a matter of public policy, the Court of Appeals should rule on the scope of section 12(2) at this time. The question of whether section 12(2) of the Securities Act governs transactions in the secondary market is one of considerable current interest in the marketplace. As noted above, the district courts which have considered the question, have not been able to provide a definitive answer. A ruling by the Court of Appeals would likely provide nationwide guidance on a question to which so far there has been none. We, therefore, will certify our Order in this case for an expedited interlocutory appeal. The question certified is as follows:

Whether Section 12(2) of the Securities Act of 1933 can be applied to fraud occurring in the secondary market.

IN THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF PENNSYLVANIA

STEPHEN J. BALLAY, ET AL	:	
	:	
v.	:	C.A. NO. 88-6867
	:	
LEGG MASON WOOD WALKER, INC.	:	

ORDER

The motion of the defendant, Legg Mason Wood Walker, Inc., for summary judgment on the record is DENIED.

The motion of the defendant, Legg Mason Wood Walker, Inc., for judgment notwithstanding the verdict or, in the alternative, for a new trial is DENIED.

The motion of the plaintiffs for summary judgment as to damages is DENIED.

Recognizing that this Order is not otherwise appealable under the statute governing interlocutory appeals, 29 U.S.C. §1292(a), and our Order involves controlling questions of law as to which there is substantial ground for difference of opinion and that an immediate appeal from the Order may materially and expeditiously advance the ultimate termination of this litigation, we shall certify this Order for an expedited interlocutory appeal pursuant to 28 U.S.C. §1292(b).

The question certified is as follows:

Whether Section 12(2) of the Securities Act of 1933 can be applied to fraud occurring in the secondary markets.

IT IS SO ORDERED.

Charles R Weiner

CHARLES R. WEINER

1933 Securities Act, 15 U.S.C. §771

Civil liabilities arising in connection with prospectuses and communications

Any person who—

(1) offers or sells a security in violation of section 77e of this title, or

(2) offers or sells a security (whether or not exempted by the provisions of section 77c of this title, other than paragraph (2) of subsection (a) of said section), by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission,

shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

1933 Securities Act, 15 U.S.C. §77q

Fraudulent interstate transactions

Use of interstate commerce for purpose of fraud or deceit

(a) It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—

(1) to employ any device, scheme, or artifice to defraud, or

(2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

Use of interstate commerce for purpose of offering for sale

(b) It shall be unlawful for any person, by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, to publish, give publicity to, or circulate any notice, circular, advertisement, newspaper, article, letter, investment service, or communication which, though not purporting to offer a security for sale, describes such security for a consideration received or to be received, directly or indirectly, from an issuer, underwriter, or dealer, without fully disclosing the receipt, whether past or prospective, of such consideration and the amount thereof.

Exemption of section 77c not applicable to this section

(c) The exemptions provided in section 77c of this title shall not apply to the provisions of this section.

1934 Securities Exchange Act, 15 U.S.C. §78j

Manipulative and deceptive devices

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

(a) To effect a short sale, or to use or employ any stop-loss order in connection with the purchase or sale, of any security registered on a national securities exchange, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Securities and Exchange Commission Rule 10b-5, 17 C.F.R. §240.10b-5 (1990)

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ and device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

IN THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF PENNSYLVANIA

STEPHEN J. BALLAY, ET AL.	:	**CIVIL ACTION**
PLAINTIFFS	:	**NO. 88-6867**
v.	:	
LEGG MASON WOOD	:	
WALKER, INC.,	:	
DEFENDANT	:	

ORDER FOR THE ENTRY OF JUDGMENT

AND NOW, this 17th day of May, 1990, it is hereby ORDERED that judgment is entered against defendant, Legg Mason Wood Walker, Inc., and in favor of plaintiffs as follows:

PLAINTIFF	DAMAGES	PREJUDGMENT INTEREST	TOTAL DAMAGE AWARD
Stephen Ballay	$ 7,021.32	$ 2,417.93	$ 9,439.25
Albert Bandosz	$14,198.61	$ 4,050.52	$ 18,249.13
Peter Beebe	$ 6,632.06	$ 2,180.55	$ 8,812.61
N. & R. Behmer	$59,474.97	$17,323.54	$ 76,798.51
Elizabeth Bell	$ 3,914.12	$ 920.92	$ 4,835.04
John Burke	$45,617.51	$14,566.97	$ 60,184.48
Agnes Broccolini	$ 2,679.34	$ 837.60	$ 3,516.94
Sophie Chelyk	$15,507.02	$ 3,102.65	$ 18,609.67
Richard Deal	$32,536.24	$11,657.91	$ 44,194.15
William Deal	$10,915.34	$ 3,243.49	$ 14,158.83
Carl Dudugjian	$36,546.52	$11,566.61	$ 48,113.13
Bobbi Espinoza	$ 6,524.88	$ 1,478.96	$ 8,003.84
George Flamm	$26,865.12	$ 7,623.41	$ 34,488.53
Frank Flansburg	$ 4,756.74	$ 1,189.66	$ 5,946.40
David Gallaher	$ 6,292.57	$ 1,931.29	$ 8,223.86
Sanford Goldfine	$78,109.53	$26,269.38	$104,378.91
Arthur Goldman	$83,754.74	$23,690.31	$107,445.05
Herbert Gould	$85,184.04	$32,031.41	$117,215.45
Robert Hoover	$63,711.58	$17,687.50	$ 81,399.08
Richard Jacobs	$24,594.93	$ 6,684.11	$ 31,279.04

PLAINTIFF	DAMAGES	PREJUDGMENT INTEREST	TOTAL DAMAGE AWARD
Manuel Marquez	$96,467.00	$28,932.35	$125,399.35
Charles Merriken	$ 9,773.33	$ 2,761.45	$ 12,534.78
Edith Munger	$ 1,538.64	$ 556.71	$ 2,095.35
Albert Resnick	$61,534.85	$18,294.74	$ 79,829.59
Ronald Richter	$ 6,942.65	$ 1,949.04	$ 8,891.69
Lawrence Smedley	$ 4,793.73	$ 1,237.59	$ 6,031.32
Peter Staniskis	$25,126.76	$ 7,424.39	$ 32,551.15
Allen Smith	$ 3,472.22	$ 993.85	$ 4,466.07
Gary Uhrman	$10,735.02	$ 2,436.55	$ 13,171.57
Philip Weyforth	$15,248.61	$ 5,643.43	$ 20,892.04
Dennis Williamson	$ 5,780.51	$ 1,819.15	$ 7,599.66
Michael Zappitelli	$ 2,091.72	$ 569.41	$ 2,661.13
Dunwoody Zook	$ 6,101.72	$ 1,284.69	$ 7,386.41
Suzanne Zook	$ 556.66	$ 137.88	$ 694.54

BY THE COURT:

Weiner, J.

5-21-90
mailed
M Feldman, Esq.
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FILED
MAY 18 1990
MICHAEL E. KUNZ, Clerk

By _____ Dep. Clerk

Supreme Court, U.S.
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No. 90-1924

In The

Supreme Court of the United States

October Term, 1990

STEPHEN J. BALLAY, *et al.*,

Petitioners,

vs.

LEGG MASON WOOD WALKER, INC.,

Respondent.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Third Circuit

RESPONDENT'S BRIEF IN OPPOSITION

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QUESTION PRESENTED

Whether Section 12(2) of the Securities Act of 1933, which makes a person who offers or sells securities in an initial distribution liable for misstatements in a "prospectus or oral communication", should be expanded to misstatements made in secondary market transactions.[1]

---

1. Petitioners contend that this case also presents the question whether Section 10(b) of the Securities Exchange Act of 1934 offers the exclusive federal remedy for misstatements in the secondary securities market. Although the opinion of the Court of Appeals addresses the evisceration of Section 10(b) that would result from expanding Section 12(2) to secondary market transactions, the court did not hold that the remedy offered by Section 10(b) is exclusive. Accordingly, the second question enumerated in the Petition would not be before this Court if it were to review this case.

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RESPONDENT'S BRIEF IN OPPOSITION

COUNTERSTATEMENT OF THE CASE

Petitioners are John Burke, a former broker and branch manager at Legg Mason Wood Walker, Inc.[2] ("Legg Mason"),

2. Legg Mason, Inc. is the parent corporation of respondent Legg Mason Wood Walker, Inc. The latter has no subsidiaries which are not wholly owned.

and forty-one of Burke's customers (collectively "the investors") who bought stock in Wickes Company, Inc. ("Wickes") at Burke's recommendation between June, 1986 and January, 1988 (R.153a). The investors did not buy Wickes stock as part of a distribution of securities; all bought Wickes in the secondary securities market. After the market price of Wickes had declined sharply and Burke had quit Legg Mason, he and his customers commenced an action to recover their trading losses.

From June, 1986 through December, 1987, as part of a routine service offered by most major brokerage firms, Legg Mason research analyst Anthony Pearce-Batten evaluated and reported on the common stock of Wickes (R.831a-832a). Batten's reports took a number of different forms, including: (a) periodic research reports and monthly updates (R.118a-152a); (b) oral reports to Legg Mason brokers in the course of telephone "squawk box" calls to the branch offices (R.484a-485a); and (c) individual conversations with Legg Mason brokers (R.742a). By August, 1987, Batten had written and Legg Mason had distributed more than one dozen reports on Wickes (R.496a, 846a-851a). These reports addressed a variety of issues, including, *inter alia,* Wickes' price history, earnings, net operating losses, debt, management and acquisitions (R.118a-143a, 998a-1003a).

The investors' claim against Legg Mason relates solely to an aspect of Wickes' worth known in the industry as book value. According to Burke, in reporting to his own Legg Mason brokers on the book value of Wickes, Batten mistakenly stated that it *ex*cluded goodwill when he should have said that it *in*cluded goodwill (R.488a). None of the investors other than Burke was privy to this alleged miscommunication (R.557a), and few would have understood it in any event (R.388a). In fact, Burke did not even discuss the book value of Wickes with most of the investors (R.387a). The error which Burke claims Batten communicated orally to the brokers as early as June, 1986, did not appear

anywhere in Batten's research reports until almost fourteen (14) months later, long after the vast majority of the investors had already purchased their shares of Wickes (R.557a). Furthermore, throughout this time period, the pertinent information regarding the book value and goodwill of Wickes was plainly and accurately set forth in the numerous publicly disseminated financial statements and corporate reports of Wickes (R.575a-576a).

At the close of the evidence at trial, the investors withdrew all counts of their complaint except those alleging liability under Section 12(2) of the Securities Act of 1933 and Section 10(b) of the Securities Exchange Act of 1934. The trial court, having previously denied Legg Mason's pretrial motion to dismiss the Section 12(2) claim on the ground that the transactions enumerated in the complaint were not part of an initial offering, denied its motion for a directed verdict as well (R.823a-824a).[3] At the close of the liability phase of the trial, the jury returned a verdict in favor of Legg Mason on the Section 10(b) claim but found against Legg Mason on the Section 12(2) claim. Legg Mason's post-trial motions were denied. On appeal, the United States Court of Appeals for the Third Circuit affirmed the judgment entered in favor of Legg Mason on the Section 10(b) claim, reversed the judgment entered against Legg Mason on the Section 12(2) claim, and remanded the matter for entry of judgment in favor of Legg Mason on the investors' Section 12(2) claim. *Ballay v. Legg Mason Wood Walker, Inc.*, 925 F.2d 682, 695 (3d Cir. 1991).

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3. In denying Legg Mason's motion for directed verdict as to Section 12(2), Judge Weiner stated on the record:

> I don't disagree with you. I think that there is very little question about it. But just out of an abundance of caution, I'm not going to decide this case. I'm going to give it to the jury to decide.

(R.824a).

SUMMARY OF ARGUMENT

Review by this Court is unwarranted. The holding below is the first and only appellate court decision respecting the applicability of Section 12(2) to secondary market transactions. The Court of Appeals' refusal to expand Section 12(2) beyond misstatements made in initial distributions conforms with the language and legislative history of Section 12(2) and follows the consensus developed in the district courts. It preserves the long-standing and well-developed right of investors who have been victimized by fraud in the secondary market to pursue their claims under Section 10(b) of the 1934 Act and the common law. Since the Circuits are not in conflict and the Court of Appeals has correctly interpreted Section 12(2), the petition should be denied.

REASONS FOR DENYING THE WRIT

I.

THE DECISION OF THE COURT OF APPEALS IS THE FIRST AND ONLY APPELLATE COURT DECISION ON THE APPLICABILITY OF SECTION 12(2) TO THE SECONDARY SECURITIES MARKET.

As the Court of Appeals in this case specifically pointed out in reaching its decision, the question whether Section 12(2) applies to transactions in the secondary market was at the time "an issue not yet ruled upon by any federal appellate court." *Ballay*, 925 F.2d at 684. *See also, Hoxworth v. Blinder, Robinson & Co., Inc.*, 903 F.2d 186, 203 (3d Cir. 1990) (noting that as of May 9, 1990, "no Court of Appeals has decided this question" of whether Section 12(2) applies to after-market purchases). It is clearly the first and only appellate court decision on the issue. In an effort to create the appearance of a conflict among the Circuits where none exists, the investors argue that "several other

Circuit Courts have expressly stated that the protection afforded to investors by Section 12(2) applies to after market transactions" (Petition at 21), and in support of their position they primarily rely on several old and inapposite Circuit Court opinions. Their assertion is plainly wrong. No other Court of Appeals has ever decided the question whether Section 12(2) applies to secondary market transactions.

The first case cited by the investors in support of their conflict argument is the 1967 opinion of the Second Circuit in *Barnes v. Osofsky*, 373 F.2d 269 (2d Cir. 1967). The plaintiffs in *Barnes* sought recovery under Section 11 of the 1933 Act for misstatements and omissions in the registration statement and prospectus which had accompanied their initial offering purchases. *Id.* at 270. The sole issue before the court in *Barnes* was "whether the district court was right in ruling that *Section 11* extends only to purchases of the newly registered shares." *Id.* at 271 (emphasis added). Since the plaintiffs never argued, and the court never confronted, a Section 12(2) claim, the statement from *Barnes* relied on by the investors is pure dictum. Not surprisingly, the Second Circuit did not feel constrained by *Barnes* when, thirteen years later, in *Gross v. Diversified Mortgage Investors*, 431 F. Supp. 1080, 1095 (S.D.N.Y. 1977), *aff'd mem.*, 636 F.2d 1201 (2d Cir. 1980), it affirmed dismissal of a Section 12(2) claim on the ground that Section 12(2) "only protects persons buying the securities specified in the registration statement and prospectus." *See also, McCowan v. Dean Witter Reynolds, Inc.*, 1989 U.S. Dist. Lexis 3711 (S.D.N.Y., April 12, 1989) (joining the "chorus finding Section 12(2) inapplicable to post-distribution transactions"); *Strong v. Paine Webber, Inc.*, 700 F. Supp. 4, 5 (S.D.N.Y. 1988) (holding that Section 12(2) does not apply to trading in secondary market). No conflict exists between the Second Circuit and the Third Circuit on the applicability of Section 12(2) to secondary market transactions.

The investors also contend that the decision of the Court of Appeals conflicts with the Tenth Circuit holding in *Woodward v. Wright*, 266 F.2d 108 (10th Cir. 1959). In *Woodward*, the plaintiffs purchased an interest in an oil and gas lease in a private offering and subsequently sought to recover under Sections 12(1) and 12(2) on the ground that the offering prospectus contained misstatements and omissions. *Id.* at 113. In reversing the judgment entered in favor of the defendant on the Section 12(2) claim, the court in *Woodward* simply held that Section 12(2) applied to both private and public offerings of securities. *Id.* at 115-16. The opinion never mentions whether Section 12(2) applies to transactions in the secondary securities market.[4]

Finally, the vast majority of the district courts that have addressed the first question presented by the investors' petition agree with the Third Circuit. Legg Mason is aware of twenty-five (25) district court decisions treating the issue.[5] Of these, nineteen (19) have held Section 12(2) *in*applicable to post-distribution

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4. In footnote 16, petitioners cite, without explanation, three other cases in support of their claim that a conflict among the Circuits exists: *Short v. Belleville Shoe Mfg. Co.*, 908 F.2d 1385 (7th Cir. 1990), *cert. denied*, 1990 Westlaw 144029 (U.S. June 28, 1991); *Schillner v. H. Vaughan Clarke & Co.*, 134 F.2d 875 (2d Cir. 1943); *Cady v. Murphy*, 113 F.2d 988 (1st Cir. 1940), *cert. denied*, 311 U.S. 705 (1940). None of these cases discusses the applicability of Section 12(2) to transactions in the secondary market, and there is no indication that the issue was ever raised in any of the cases.

5. In addition to those cases cited by the petitioners at footnote 17, five other cases have held Section 12(2) inapplicable to secondary market transactions: *Pacific Dunlop Holdings, Inc. v. Allen & Co., Inc., et al.*, 1991 U.S. Dist. Lexis 6748 (N.D. Ill., May 15, 1991); *Bank of Denver v. Southeastern Capital Group, Inc., et al.*, 1991 U.S. Dist. Lexis 6452 (D. Colo., May 9, 1991); *Leonard v. Stuart-James Co., Inc., et al.*, 742 F. Supp. 653 (N.D. Ga. 1990); *Klein v. Computer Devices, Inc.*, 591 F. Supp. 270 (S.D.N.Y. 1984); *Gross v. Diversified Mortgage Investors*, 431 F. Supp. 1080 (S.D.N.Y. 1977), *aff'd*, 636 F.2d 1201 (2d Cir. 1980).

trading. Both district courts that have addressed the issue since the opinion of the Court of Appeals have specifically adopted its reasoning. *See Pacific Dunlop Holdings, Inc. v. Allen & Co., Inc., et al.*, 1991 U.S. Dist. Lexis 6748 (N.D. Ill., May 15, 1991) ("We are persuaded by the reasoning in *Ballay v. Legg Mason Wood Walker, Inc.* . . . and hold that Section 12(2) applies only to initial offerings and not to after market trading."); *Bank of Denver v. Southeastern Capital Group, Inc., et al.*, 1991 U.S. Dist. Lexis 6452 (D. Colo., May 9, 1991) ("After consideration of the statute and the cases interpreting it, I adopt the rule of the Third Circuit."). This Court should allow the consensus to continue to build, and intervene only when, and if, a true and focused conflict develops.

II.

THE DECISION OF THE COURT OF APPEALS CONFORMS WITH THE LANGUAGE AND LEGISLATIVE HISTORY OF SECTION 12(2).

This Court should only review this case if there is evidence of a mistake that needs correction or an inequity that demands redress. Neither is present here. The Court of Appeals' interpretation of Section 12(2) is natural, uncontrived and fully supported by the language and legislative history of the 1933 Act.

A. Section 12(2) Is Limited By Its Language To Misstatements Made In Connection With Initial Distributions.

By its terms, Section 12(2) applies only to those persons who offer or sell securities "by means of a prospectus or oral communication." 15 U.S.C. § 771(2).[6] As Legg Mason has

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6. Section 12(2) provides as follows: "Any person who — (2) offers or sells a security (whether or not exempted by the provisions of § 77(c) of this (Cont'd)

contended from the start, and as the Court of Appeals agreed, the use of the term "prospectus" to describe the written communications to which Section 12(2) applies makes clear that Congress intended to limit the section to initial offerings. As the court below concluded, "prospectus" in the context of the 1933 Act is a term of art which refers to the communication of information in initial distributions. 925 F.2d at 688. In support of their petition, the investors contend that the Court of Appeals erred in reading "prospectus" so narrowly. This contention is based entirely on a misinterpretation of the pertinent statutory language.

The term "prospectus" appears forty-two (42) times in the text of the 1933 Act. Section 2(10) — the section on which the investors rely exclusively to support their argument that "prospectus" means any "written communication" — defines only the form which a prospectus *may* take. As the substantive provisions of the 1933 Act demonstrate, however, a writing is not a "prospectus" merely because it takes on one of the forms enumerated in Section 2(10). Those documents which may, *in form*, constitute a prospectus are only, in fact, prospectuses if

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(Cont'd)
title other than paragraph (2) of subsection (a) of said section), by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission, shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security." 15 U.S.C. § 771(2).

used for the purposes set forth in Section 5.[7] If a document takes on one of the forms enumerated in Section 2(10) and fulfills the function set forth in Section 5, it must then comply with Section 10, which requires that the prospectus contain, with certain exceptions, the detailed information set forth in the registration statement. Even the investors would concede that Sections 5 and 10 deal exclusively with initial distributions. Since "prospectus" is functionally defined by Sections 5 and 10 to concern only initial offerings, it simply cannot have been intended to include documents outside the context of an initial offering. Indeed, if Congress had intended "prospectus" to mean any "written communication", as the investors now suggest, it would have said so.

It follows that the phrase "or oral communication" in Section 12(2) must be similarly limited to the context of initial distributions. Since the phrase "oral communication" is not defined in the Act, it must be understood "in light of the words that accompany it and give [it] meaning". *Massachusetts v. Morash*, 490 U.S. 107, 115 (1989). This Court has noted the importance of construing the meaning of one term in a phrase consistent with the other words in the phrase:

> [t]he maxim *noscitur a sociis*, that a word is known by the company it keeps, while not an inescapable rule, is often wisely applied where a word is capable of many meanings in order to avoid the giving of unintended breadth to the Acts of Congress.

Jarecki v. G.D. Searle & Co., 367 U.S. 303, 307 (1961). Applying this maxim to the plain meaning of "prospectus or oral

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7. For example, Section 2(10) expressly provides that documents sent to a buyer will *not* be deemed prospectuses, regardless of their form, if the buyer previously received the prospectus required by Section 5.

communication" in Section 12(2), the Court of Appeals correctly interpreted these words to mean that buyers may recover only for material misrepresentations made in a prospectus, or in an oral communication related to an initial offering. *Ballay*, 925 F.2d at 688.

In an effort to fit this case within the reach of *United States v. Naftalin*, 441 U.S. 768 (1979), the investors also labor to identify similarities between Section 12(2) and Section 17(a) of the 1933 Act. First, while Section 12(2) by its express terms applies only to one who offers or sells a security "by means of a prospectus or oral communication", Section 17(a) contains no such limitation. Indeed, Section 17(a) contains no reference to "prospectus" at all. Rather, Section 17(a) contains broad antifraud language almost identical to that of Section 10(b) of the 1934 Act and Rule 10b-5 promulgated thereunder, which do, indeed, extend to secondary market trading. Second, this Court specifically noted in *Naftalin* that Section 17(a) represents a "major departure from [the] limitation" that the Securities Act of 1933 was primarily concerned with the regulation of new offerings of securities. 441 U.S. at 777-78. Unlike the legislative history of Section 12(2), (*see* Section II (B), *infra*), the legislative history of Section 17(a) explicitly demonstrates an intention to apply Section 17(a) to transactions in both the primary and secondary securities market. Finally, *Naftalin* did not involve a private action by an individual investor seeking monetary damages. *Naftalin* involved a criminal proceeding under Section 17(a)(1).

B. Congress Did Not Intend Section 12(2) For Secondary Market Transactions.

The legislative history, as well as the statutory language of Section 12(2), fully support the conclusion reached by the Court

of Appeals. In addressing the civil liability provisions of Sections 11 and 12 of the 1933 Act, the House Committee first stated:

> The committee emphasizes that these liabilities attach *only* when there has been an untrue statement of material fact or an omission to state a material fact *in the registration statement or the prospectus* — the basic information by which the public is solicited.

H.R. Rep. No. 85, 73d Cong., 1st Sess. (1933) at p. 9 (emphasis added). The House further observed:.

> [Sections 11 and 12] entitle the buyer of securities sold upon *a registration statement* including an untrue statement or omission of material fact, to sue for recovery of his purchase price, or for damages not exceeding such price, those who have participated in such *distribution* either knowing of such untrue statement or omission or having failed to take due care in discovering it.

Id. (emphasis added). The House concluded that the Act "throws upon originators of securities a duty of competence as well as innocence which the history of recent spectacular failures overwhelmingly justifies." *Id.* Congress could not have been clearer in stating its intentions with respect to the limits of Section 12(2).

Consideration of Section 12 in the larger legislative scheme of the 1933 Act fully supports this conclusion. Even the investors would not dispute that the 1933 Act was intended primarily to protect the public from unscrupulous issuers, underwriters and distributors of newly issued securities and to rid the marketplace of worthless investments. The Act sought to accomplish this by

encouraging the free flow of information to potential investors, and to ensure the accuracy of this information it imposed both significant obligations and severe sanctions on those with superior knowledge of the material facts regarding the worth of such securities. Recognizing that issuers, underwriters and distributors of new issues possessed both a complete monopoly on investment information and a significant financial incentive to withhold such information from the investing public, the drafters of the 1933 Act countered with substantial and very one-sided disclosure obligations and severe penalties for failure to satisfy these obligations. In turn, realizing that buyers of such new issues would have almost no opportunity to become informed about securities from any other source, the drafters placed no obligation on them to do so. Section 12(2), which makes sellers virtual insurers of the information they communicate to potential investors and provides defrauded purchasers with rescissory damages, is perfectly consistent with this legislative scheme.

In the context of initial offerings, where the flow of information is one-sided and the incentive to withhold is great, such a claim is easily justified, if not demanded. In the secondary market, where buyer and seller deal at arm's length often in faceless transactions over national exchanges, the security is well known to the marketplace and the financial incentive of research analysts such as Batten to prefer one security over another simply does not exist, the same type of claim has no place. Both parties to the transaction should have at least some obligation to keep abreast of publicly available information, and only intentional or reckless misstatements or omissions of the kind which Section 10(b) of the 1934 Act is designed to punish should justify liability.

C. The Expansion Of Section 12(2) To Secondary Market Transactions Would Lead To Unreasonable Results.

For more than four decades, Section 10(b) of the 1934 Act

has offered a private cause of action for misstatements in the secondary market. *See, e.g., Kardon v. National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946). During that time, Section 10(b) has been the subject of considerable jurisprudential development and the standards for liability under that section have been carefully defined. The extension of Section 12(2) and its much less stringent standards of liability to the misconduct currently governed by Section 10(b) would effectively overrule 40 years of precedent with respect to scienter, reliance and loss causation.[8] An investor can recover under Section 12(2) simply by showing that the defendant (1) offered or sold a security by means of a prospectus or oral communication, (2) misstated or failed to state a material fact, and (3) knew or should have known of the untruth or omission while the investor did not know of the untruth or omission. *Monetary Management Group, Inc. v. Kidder, Peabody & Co.*, 615 F. Supp. 1217, 1221-22 (E.D. Mo. 1985). He need not prove scienter, reliance or loss causation.[9] Extending Section 12(2) to secondary market transactions would bring about the virtual extinction of Section 10(b). It would also be inconsistent

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8. *See Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976) (under Section 10(b) a plaintiff must establish, *inter alia*, that the defendant acted recklessly or with an intent to deceive known as scienter); *Sharp v. Coopers & Lybrand*, 649 F.2d 175 (3d Cir. 1981), *cert. denied*, 455 U.S. 938 (1982) (Section 10(b) imposes upon the plaintiff a stringent reliance requirement); *Sims v. Faestel*, 638 F. Supp. 1281 (E.D. Pa. 1986), *aff'd*, 813 F.2d 399 (3d Cir. 1987) (the plaintiff in a Section 10(b) claim must establish a direct causal relationship between the alleged misrepresentation and the loss).

9. *See* L. Loss, *Fundamentals of Securities Regulation*, 892 (2d Ed. 1988) (Section 12(2) is limited to "*intentional* or *negligent* misstatements or omissions) (emphasis in original); *Woodward v. Wright*, 266 F.2d at 116 ("[t]o say that purchaser reliance is a prerequisite to seller liability is to import something into the statute [12(2)] which is not there"); *Hill York Corp. v. American International Franchises, Inc.*, 448 F.2d 680, 696 (5th Cir. 1971) ("[a] causation test should not be read into [Section (12(2)]").

with *Hochfelder, supra*, in which this Court held that Congress intended otherwise in enacting Section 10(b).

The investors, apparently understanding the significance of the radical departure from *Hochfelder* implicit in their position, contend that it is simply the converse of this Court's holding in *Herman & MacLean v. Huddleston*, 459 U.S. 375 (1983). In *Huddleston*, this Court held that purchasers with claims under Section 11 for untrue statements in registration statements may also seek recovery under Section 10(b) of the 1934 Act. *Id.* at 387. As the Court noted, its holding did not affect the standards for liability under Section 11 or impact the continuing vitality of Section 10(b). What the investors seek in this case — the elimination of an existing Section 10(b) claim, with its higher standards of liability, by the substitution of Section 12(2) with its lower standards — is clearly not supported by anything in *Huddleston*.

The investors' interpretation of Section 12(2) also lacks any semblance of logical consistency. For example, if adopted, their interpretation would inexplicably create new remedies for defrauded buyers that, by the language of Section 12(2), cannot extend to defrauded sellers. While both defrauded buyers and defrauded sellers may recover under Section 10(b), "[a] defrauded seller has no cause of action under section 12(2)". *Hoxworth, supra*, at 203 n. 25. In the context of initial offerings, the obvious contrast between an acute concern for defrauded buyers and the absence of *any* civil damage remedy for defrauded sellers makes complete sense. Only purchasers can be injured by misinformation in an initial offering context. In the secondary market, where defrauded sellers may, in fact, even outnumber defrauded buyers, it makes no sense at all.

This differentiation between defrauded sellers and defrauded buyers becomes even more apparent when one considers the

different remedies available under the two statutes. Under Section 10(b), a defrauded buyer's only remedy is "actual damages". 15 U.S.C. § 78bb(a). Under Section 12(2), on the other hand, the defrauded buyer is entitled to a rescissory measure of damages equal to the difference between the price he paid for the securities and the price at which they were sold. *Randall v. Loftsgaarden*, 478 U.S. 647, 655-56 (1986). The difference is, of course, that under Section 12(2) a defrauded buyer can recover not only the loss created by the misrepresentation but the intervening market losses as well, without any proof of scienter, reliance or loss causation. Under the investors' version of Section 12(2), even if the defrauded seller had proven each of those elements, he would still receive as compensation only his out-of-pocket loss. As the Court of Appeals recognized, such differentiation represents a drastic and unjustified departure from the even-handed judicial development of the federal securities laws.

The investors also argue that unless Section 12(2) is extended to misstatements in secondary market transactions the remedies provided by Section 11 and Section 12(2) will be redundant. This is simply not true. Section 12(2) governs transactions and parties outside the scope of Section 11. In particular, Section 11, by its terms, governs only defects in registration statements and provides no protection for initial offerings not subject to the registration requirements of the 1933 Act. Section 12(2), on the other hand, protects persons who purchase registered or unregistered securities in an initial distribution. Additionally, Section 11 imposes liability only on particular persons directly involved in the issuance such as signers of the registration statement, the directors of the issuer, and the underwriters. Section 12(2), on the other hand, establishes liability for "any person who offers or sells a security . . . . " Lastly, by the specific language of Section 10(b) of the 1933 Act, Section 11 is wholly inapplicable to prospectuses. 15 U.S.C. § 77j(b). By contrast, Section 12(2) covers both prospectuses and oral statements related to initial offerings, a category of

misstatements that is not even addressed in Section 11. Section 12(2), properly understood, does not merely duplicate the remedies available under Section 11.

Finally, the investors suggest that unless Section 12(2) is expanded to include the secondary market, injured buyers of securities in that market will be left without an adequate remedy for their loss. This is simply not the case. Those who have been victimized by fraud, misrepresentation or even reckless misstatements in connection with a secondary market transaction are not without recourse. They may, like the investors in this case, assert a claim under Section 10(b) of the 1934 Act. They may also pursue their rights under the common law through claims such as negligence, fraud and breach of fiduciary duty. As the Court of Appeals properly recognized, the creation of an additional remedy through an expanded application of Section 12(2) would be both unnecessary and unjustified.

CONCLUSION

Based on the foregoing, it is respectfully submitted that the investors' petition for a writ of certiorari should be denied.

Respectfully submitted,

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